TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1944

No. 93

W. G. CHOATE, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR CERTIORARI FILED MAY 23, 1944.

CERTIORARI GRANTED OCTOBER 9, 1944.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

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COMMISSIONER OF INTERNAL REVENUE

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INDEX

	Original	Print
Proceedings in U. S. C. C. A., Tenth Circuit	1	1
Petitioner's designation of parts of the record to be printed	1	1
Cross-petitioner's designation of parts of the record to be printed	2	1
Caption (omitted in printing)	2	
Record from The Tax Court of the United States		
Amended petition	3	2
Exhibits:		
"A"—Notice of deficiency	7	5
Statement	8	6
"B"—Partial assignment of oil and gas lease, December 3, 1936, Continental Oil Co. to Roy R. Brown (omitted in printing)	9	
"C"—Instrument dated December 18, 1936, executed by Roy R. Brown assigning interest in lease to Fred T. Hogan and L. H. Choate (omitted in printing)	15	
"D"—Assignment of oil and gas lease, August 22, 1938, L. H. Choate and Fred T. Hogan to Sylva Oil Company	18	8
Answer to amended petition read into the record	24	13
Memorandum findings of fact and opinion	24	13
Decision	34	23
Petition for review	35	23
Petitioner's statement of points relied on	38	26

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., NOVEMBER 13, 1944.

—4960

Record from The Tax Court of the United States—Continued	Original	Print
Cross-petition for review	39	27
Cross-petitioner's statement of points relied on	39	27
Order enlarging time to docket petition for review	41	29
Order enlarging time to docket cross-petition for review	42	30
Agreed statement of facts	42	30
Petitioner's exhibits:		
1—Oil and gas lease, September 8, 1924, between Mrs. M. L. Baker and G. A. Tunstill (omitted in printing)	48	
2—Assignment of oil and gas lease, July 7, 1925, G. A. Tunstill to Marland Oil Company of Texas (omitted in printing)	59	
3—Assignment, July 1, 1929, of assets of Marland Production Company to Continental Oil Company (omitted in printing)	61	
4—Division order, March 10, 1937, Humble Oil & Refining Company (omitted in printing)	63	
5—Assignment by Sylva Oil Company of interest in certain oil to Humble Oil & Refining Company (omitted in printing)	66	
6—Journal entry voucher of Sylva Oil Company (omitted in printing)	68	
7—Contract, August 11, 1938, between Choate and Hogan and The McAlester Fuel Company	69	36
8—Letter, August 22, 1938, The McAlester Fuel Company to L. H. Choate and Fred T. Hogan	73	40
9—Letter, August 19, 1938, Choate & Hogan to Continental Oil Company (omitted in printing)	73	
10—Letter, August 22, 1938, Sylva Oil Company to L. H. Choate (omitted in printing)	74	
11—Letter, August 22, 1938, M. J. Bonham to Fred T. Hogan (omitted in printing)	75	
Docket entries	76	40
Clerk's certificate (omitted in printing)	78	
Order of submission	79	42
Opinion, Kennedy, J.	79	43
Judgment	83	47
Petition for rehearing	85	47
Order denying petition for rehearing	94	53
Clerk's certificate (omitted in printing)	94	
Order allowing certiorari	96	54
Stipulation as to printing of record	97	54

[fol. 1]

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 2789

W. G. CHOATE, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

No. 2790

COMMISSIONER OF INTERNAL REVENUE, Cross Petitioner,

v.

W. G. CHOATE, Cross Respondent

DESIGNATION OF PARTS OF RECORD TO BE PRINTED—Filed August 16, 1943

The Taxpayer W. G. Choate designates the following portions of the record to be printed as the consolidated record in the above cases:

Docket Entries.
Amended Petition.
Answer to Amended Petition read into record.
Agreed Statements of Facts.
Exhibits 1-11 inclusive.
Memorandum Findings of Fact and Opinion.
Decision.
Taxpayer's Statement of Points.
Commissioner's Statement of Points.

Vinson, Elkins, Weems & Francis, by James H. Yeatman, Attorney for Taxpayer.

[fol. 2] Service of copy of this designation acknowledged this 12th day of August, 1943.

Sam'l O. Clark, Jr., Attorney for Commissioner.

[File endorsement omitted.]

[Cross-petitioner's designation filed August 11, 1943, is identical with petitioner's designation which appears on page 1.]

[Caption omitted.]

[fol. 3] BEFORE THE UNITED STATES BOARD OF TAX APPEALS, WASHINGTON, D. C.

DR. W. G. CHOATE, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 107,888

AMENDED PETITION—Filed May 5, 1942

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols: Dallas-Ira:90-D-D) dated March 20, 1941; and as a basis of his proceedings alleges as follows:

I

The petitioner is an individual with principal offices located at Cisco, Texas. The return for the period here involved was filed with the Collector of Internal Revenue for the Second District of Texas, at Dallas, Texas.

II

The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on March 20, 1941.

III

The taxes in controversy are income taxes for the calendar year 1938, and in the amount of $2,015.58.

IV

The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) In this determination of petitioner's distributive share of the partnership income of Choate and Hogan for [fol. 4] the year 1938, the respondent erred in his determination that said partnership did not make a sale of an interest in the Baker lease during said year and in failing and refusing to compute the gain or loss thereon in the manner

provided by law for computing the gain or loss on the sale of property;

(b) If it be determined that his interest in the Baker leasehold estate was not sold, then it is averred in the alternative that the members of the partnership parted with all of their rights, title and interest in and to the equipment of said leasehold estate, and that respondent erred in not reducing the gain which he determined that the partnership realized on the transaction by the full amount of the depreciated cost of the equipment on said lease, which amounted to $23,090.60;

(c) If it be determined that neither an interest in the Baker leasehold estate, nor the equipment thereon, was sold during the taxable year, then it is averred in the alternative, that respondent erred in not reducing the gain realized on the transaction by cost depletion according to the depleted leasehold cost plus the depreciated equipment cost, which amounted to $46,674.38, at the time the transaction occurred.

V

The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) (b) Capital Gain from Sale of Baker Lease

Under date of December 3, 1936, the Continental Oil Company of Ponca City, Oklahoma, executed an instrument bearing the caption "Partial Assignment of Oil and Gas Lease,"—to Roy R. Brown of Amarillo, Texas. The instrument in question relates to what is known as the Baker Lease; and a copy of such instrument is attached hereto marked Exhibit "B".

Under date of December 18, 1936, the said Roy R. Brown executed a written instrument under the terms of which an interest in the Baker Lease was assigned to Fred T. Hogan and L. H. Choate; and a copy of such instrument is attached hereto and marked Exhibit "C".

[fol. 5] Upon receipt of the Baker Lease from the said Roy R. Brown, the said Fred T. Hogan and L. H. Choate proceeded to organize a certain joint venture (or partnership) known as Choate & Hogan of Midland, Texas. It was understood and agreed that the said Choate & Hogan

would own, develop, and operate the Baker Lease, owning property and *shawing* in profits and losses as follows:

	Interest
Choate and Choate	50%
Fred T. Hogan (and wife)	50%
Total	100%

Thereafter, Choate and Hogan did proceed to develop and operate the Baker Lease; and, under date of August 22, 1938, L. H. Choate and Fred T. Logan executed a certain instrument described as "Assignment of Oil and Gas Lease, L. H. Choate and Fred T. Hogan to Sylva Oil Company." The instrument in question relates to the sale of the Baker Lease to the Sylva Oil Company, and a copy of such instrument is attached hereto and marked Exhibit "D".

During the said year 1938, Choate & Hogan realized a gain from the sale of the Baker Lease to the Sylva Oil Company (including a loss from the sale of equipment situated on said lease), a statement of which follows:

[fol. 6]

	Leasehold	Equipment	Total
Sale Price	$98,454.70	$11,545.30	$110,000.00
Less Cost of Sale: Gross Cost	$33,391.80	$30,206.49	$ 63,598.29
Less—Reserves for Depletion and Depreciation	9,808.02	7,115.89	16,923.91
Net Cost of Sale	$23,583.78	$23,090.61	$ 46,674.38
Gross Gain from Sale	$74,870.92	*$11,545.80*	$ 63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	*$11,545.80*	$ 60,325.62
Taxable Gain from Sale (Section 117, Revenue Act of 1938)	$47,913.95	*$11,545.80*	$ 36,368.65

* Figures in italics in red on typewritten copy.

In his notice of deficiency, the respondent determined that Choate & Hogan realized from the transaction under consideration an alleged "bonus" arising from the sublease of the Baker Lease to the Sylva Oil Company,—a summary statement of which follows:

"Oil Income"		$110,000.00
Less—Depletion	$30,250.00	
Less—Commission	$3,000.00	33,250.00
Net Income		$ 76,750.00

As above stated, the said Baker Lease was owned and operated by a certain partnership, known as Choate and Hogan; and the members of that firm were Choate and Choate and Fred T. Hogan and Wife. The said Choate and Choate is likewise a partnership, the members thereof being L. H. Choate and wife (50 percent) and Dr. W. G. Choate (50 percent).

Wherefore, the petitioner prays that the Board may hear [fol. 7] the proceedings and determine that there is no deficiency in the tax for the year 1938, in any amount whatsoever.

Signed, James H. Yeatman, Counsel for Petitioner, 11th Floor Esperson Building, Houston, Texas.

April 29, 1942.

Duly verified by Dr. W. G. Choate.

EXHIBIT "A" TO AMENDED PETITION

Treasury Department, Internal Revenue Service, 422 Federal Building, Dallas, Texas

Dallas Diyision.

Dallas IRA :90D-D

Dr. W. G. Choate, c/o L. H. Choate, Cisco, Texas.

SIR:

Your are advised that the determination of your income tax liability for the taxable year ended December 31, 1938, discloses a deficiency of $2,015.58 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, for the attention of G:RLP. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing [fol. 8] the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner, by (Signed) B. W. Wilde, Internal Revenue Agent in Charge.

Enclosures: Statement, Form of Waiver.
EWG/md

STATEMENT

Dallas IRA:90D-D

Dr. W. G. Choate, c/o L. H. Choate, Cisco, Texas.

Tax Liability for the Taxable Year Ended December 31, 1938

	Liability	Assessed	Deficiency
Income Tax	$2,832.77	$817.19	$2,015.58

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated August 31, 1940; to your protest executed October 11, 1940; and to the statements made at the conference held on December 9, 1940.

A copy of this letter and statement has been mailed to your representative, Mr. Claude Collard, 403 Petroleum Building, Fort Worth, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

Adjustment to Net Income

Net income as disclosed by return	$13,674.46
Additional income: (a) Partnership income	12,753.03
Net income adjusted	$26,427.49

Explanation of Adjustment

(a) Income from partnership of Choate and Choate and Chioate reported in the amount of $13,674.46 increased by $12,753.03 to $26,427.49 to include in gross income your [fols. 9-17] distributable portion of the corrected net income of the partnership, as shown by report covering examination of the partnership, a copy of which report has been furnished the partnership. The adjustment is shown as follows:

	Partnership Income		
	Reported	Corrected	Adjustment
Ordinary income	None	$22,047.57	$22,047.57
Ordinary loss	$(2,784.11)	none	2,784.11
Long-term capital gain	11,978.48	none	(11,978.48
Short-term capital gain	4,480.09	4,379.92	(100.17)
Total	$13,674.46	$26,427.49	$12,753.03

Computation of Tax

Net income adjusted	$26,427.49
Less: Personal exemption	2,500.00
Balance (Surtax net income)	$23,927.49
Less: Earned income credit (10% of $3,000.00)	300.00
Net income subject to normal tax	$23,627.49
Normal tax at 4% on $23,627.49	945.10
Surtax on $23,927.49	1,887.67
Correct income tax liability	$2,832.77
Income tax assessed, account #200801	817.19
Deficiency of income tax	$ 2,015.58

• • • • • • •

[fol. 18] EXHIBIT "D" TO AMENDED PETITION

Assignment of Oil and Gas Lease, L. H. Choate and Fred T. Hogan to Sylva Oil Company

THE STATE OF TEXAS,
County of Upton:

Whereas, on the 8th day of September, 1924, a certain oil and gas mining lease was made and entered into by and between Mrs. M. L. Baker (nee Greenwade), as Lessor, and G. A. Tunstill, as Lessee, covering among other lands, the following described lands in Upton County, Texas, to-wit:

A portion of Survey No. 7, in Block "R" certificate No. 563, Confd, Scrip. to M. S. Denton, described by metes and bounds as follows:

Beginning at a stake, the east corner of a survey of 1280 acres in the name of E. C. Grooms, same being the North corner of survey No. 7, Block "R", M. S. Denton; thence S. 50 deg. E 1124.4 varas to the most northerly southeast corner of this tract; thence 40 deg. W 237.6 varas to the most easterly inside corner of this tract; thence S 50 deg. [fol. 19] E 237.6 varas to the most southerly southeast corner of this tract; thence S 40 deg. W 418.4 varas to the east corner of a tract of land containing 80 acres assigned by Continental to Chas. L. Morgan by instrument dated November 13, 1925; thence N 50 deg. W with the NE B. L. of said Morgan tract 672 varas to its north corner; thence S 40 deg. W with the NW B. L. of said Morgan tract 672 varas to its west corner; thence N 50 deg. W 688 varas to a point in the NW B. L. of Survey No. 7, Block "R" M. S. Denton, the most westerly corner of this tract; thence N 40 deg. E 1328 varas with the NW B. L. of said Survey No. 7 to the place of beginning, containing 230 acres of land, more or less,

said lease being of record in Vol. 18, pp. 523-527 of the Oil and Gas Lease records of said county, and having been executed in lieu of and for the purpose of correcting, that certain oil and gas lease made and entered into by and between the said Mrs. M. L. Baker and her husband, J. Holmes Baker, bearing the same date and recorded in Vol. 17, p. 43, of the Oil and Gas Lease Records of said county; and

Whereas, said lease and all rights thereunder, in so far as same covers the above specifically described land, was assigned to Roy R. Brown by Continental Oil Company by instrument dated December 3, 1936, recorded in Volume 50, page 381, of the deed records of Upton County, Texas, such assignment being of all oil and gas rights down to the depth of 2750 feet from the surface (all oil, gas and casinghead gas, and the oil, gas and casinghead rights, below said depth of 2750 feet being specifically reserved by the Continental Oil Company) and the Continental Oil Company expressly reserving in said instrument 1/16 of all of the oil, gas or casinghead gas produced, saved and sold, from said specifically described land from depths not exceeding 2750 feet from the surface; which said assignment and its record are here now referred to and made a part hereof for all purposes;

And whereas, said lease and all rights thereunder, in [fol. 20] so far as same covers the above specifically described land and down to the depth of 2750 feet from the surface and subject to the terms and conditions and the said reservation of 1/16th overriding royalty in said assignment from the Continental Oil Company to Roy R. Brown, hereinbefore referred to, are now owned by L. H. Choate and Fred T. Hogan.

Now, therefore, for and in consideration of One Dollar ($1.00) and other good and valuable considerations, the receipt of which is hereby acknowledged, the undersigned L. H. Choate and Fred T. Hogan, the present owners of said lease, as hereinabove set out, and all rights thereunder or incident thereto down to the depth of 2750 feet, subject to all the terms and conditions and the said reservation of 1/16 overriding royalty in said assignment from the Continental Oil Company to Roy R. Brown, do hereby bargain, sell, assign and convey, subject to all of the terms and conditions, and the reservation of 1/16th overriding royalty in said asignment from Continental Oil Company to Roy R. Brown, all right, title and interest of the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, in so far as the same covers and affects the oil gas and casinghead gas, and the oil, gas and casing gas rights, at *an* above the depth of two thousand seven hundred fifty feet from the surface in and under the said 230 acres of land above described,

together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignors herein expressly reserve to themselves, their heirs and assigns, and do not assign or convey to the assignee herein, 1/8 of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company, its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred and fifty feet from the surface under and by virtue of the lease above mentioned, delivery of such part of the oil, gas and casinghead gas to be made free of cost [fol. 21] to the assignors in the storage tanks by them provided on said property or into the pipe line to which the wells on said premises may be connected; such reservation of overriding royalty or share of production to be 1/16th of the 8/8ths in favor of L. H. Choate and 1/16th of the 8/8ths in favor of Fred T. Hogan.

It being, however, expressly understood and agreed by and between the parties hereto that assignee shall, with reasonable diligence, being the drilling of a well prospecting for oil and gas on some part of said property and will drill the same with due diligence to completion and further, that said assignee will continue the drilling of said property, after the drilling of said first well, with due and reasonable diligence, until such time as the property is reasonably developed; the obligation on assignee to so drill such property being subject only to such valid spacing and proration rules and regulations as may be imposed by the proper authorities, and to conditions happening or becoming known which would cause a reasonably prudent operator to refrain for the time being or indefinitely from drilling additional wells.

It being further understood and agreed that if assignee herein, its successors and assigns, should decide at any time to abandon or sell any well or wells, less than the whole number of wells on the premises, the production from which has been seriously depleted, which said well or wells have been drilled on said lease, assignors herein, their heirs, successors or assigns, shall have the option to purchase such well or wells at the highest bona fide offer

that assignee may have received for the same; any such well or wells to carry with it ten (10) acres in the form of a square (as nearly as practicable) around each well. Assignors, their heirs and assigns, will be required to exercise their right to purchase such well or wells under such conditions within five (5) days after the opportunity is given them to so purchase the same.

And for the same considerations, the undersigned for themselves, their heirs, successors and assigns, do covenant with the said assignee, its successors or assigns, that they [fol. 22] are the lawful owners of the said lease down to the depth of 2750 feet from the surface and the rights and interests thereunder, but subject to all of the terms, conditions, reservations and limitations set out in said contract of assignment from the Continental Oil Company to Roy R. Brown, above mentioned, and are the lawful owners of all the wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with such premises, including oil in storage; that they have good right and authority to sell and convey the same and that the herein conveyed rights, interests and property are free and clear from all liens and incumbrances, and that all rentals and royalties due and payable thereunder have been duly paid, and that all terms and conditions of said assignment from Continental Oil Company to Roy R. Brown, and of the assignment from Roy R. Brown to the assignors herein, have been fully performed to date, and that the undersigned will warrant and defend the title herein conveyed (which as aforesaid, does not include the 1/16th overriding royalty reserved in that certain contract of assign-ent from the Continental Oil Company to Roy R. Brown, hereinabove mentioned, or the 1/8th overriding royalty herein reserved by assignors) against the lawful claims or demands of all persons whomsoever.

This assignment shall be effective as of date August 15, 1938, at 7:00 A. M. For purpose of division between assignors and assignee, 12/27ths of the production from said lease for the month of August 1938, shall be attributed to the period prior to 7:00 A. M., August 15th, 1938, and 15/27ths of the production for August 1938, shall be attributed to the period after said hour and date.

Assignors will pay all taxes for the year 1938, and assignee will reimburse assignors for 3/8ths of the amount hereof.

This instrument is also executed by Sylva Oil Company as an indication of its acceptance of all the terms and conditions hereof.

[fol. 23] Executed this the 22 day of August, A. D. 1938.

L. H. Choate, Fred T. Hogan, Assignors. Sylva Oil Company. By J. G. Puterbaugh, President. Assignee. (Seal.)

Approved:

Locke, Locke, Stroud and Randolph, Attys.

The State of Texas,
County of Midland:

Before me, the undersigned, a Notary Public in and for said county and state, on this day personally appeared L. H. Choate and Fred T. Hogan, known to me to be the persons whose names are subscribed to the foregoing instrument and acknowledged to me that they each executed the same for the purposes and conditions therein expressed.

Given under my hand and seal of office this the 22 day of August, A. D. 1938.

Gertrude Harris, Notary Public in and for Midland County, Texas.

The State of Texas,
County of Dallas:

Before me, the undersigned, a Notary Public in and for said County and State, on this day personally appeared J. G. Puterbaugh, known to me to be the person and officer whose name is subscribed to the foregoing instrument and acknowledged to me that the same was the act of the said Sylva Oil Company, a Texas corporation, and that he executed the same as the act of such corporation for the purposes and consideration therein expressed, and in the capacity therein stated.

Given under my hand and seal of office this the 22 day of August, A. D. 1938.

Gertrude Harris, Notary Public in and for Dallas County, Texas.

[fol. 24] IN THE TAX COURT OF THE UNITED STATES

EXCERPT FROM TRANSCRIPT OF TESTIMONY

ANSWER TO AMENDED PETITION READ INTO THE RECORD

Mr. Schlosser: In answer to the amended petitions, filed in the cases of Fred T. Hogan, L. H. Choate, Lucille Choate and Dr. W. G. Choate, the respondent denies that he erred in the manner alleged in sub-paragraph (a) to (e) inclusive, in paragraph IV in the petition.

As to this paragraph V, of each of the amended petitions the commissioner denies the allegations thereof, with the exception that it is admitted that the commissioner determined that Choate and Hogan realized a net ordinary gain of $76,750.00 from the Baker lease transaction, and that Fred Hogan owned a fifty percent interest in the Choate and Hogan partnership, as alleged in sub-paragraph (a) and (b); in sub-paragraph (e) the commissioner denies the allegations contained in that sub-paragraph.

As to the sub-paragraph (d) of paragraph V of the amended petitions in each case, the respondent denies the allegations contained therein, with the exception that it is admitted that during the year 1938, Fred T. and Novadean Hogan made a sale of the Sanger lease.

Respondent denies each and every material allegation not heretofore specifically admitted or denied in each amended petition.

Filed May 16, 1942.

IN THE TAX COURT OF THE UNITED STATES

Docket Nos. 107630, 107631, 107886, 107887, 107888

James H. Yeatman, Esq., and Claude Collard, C. P. A., for the petitioners. Frank B. Schlosser, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION—Dec. 9, 1942

OPPER, J.:

These consolidated proceedings challenge income tax deficiencies determined by respondent for the year 1938 as follows:

[fol. 25] Fred T. Hogan	$3,671.81
Nevadena Hogan	12.21

L. H. *Choste*	632.85
Lucille Choate	632.85
W. G. Choate	$2,015.58

The questions presented are (1) whether a transaction involving an oil and gas lease gave rise to capital gain or ordinary income, (2) the proper treatment for purposes of depreciation of the equipment on the lease, and (3) whether the taxable income arising out of the assignment of the lease and attributable to the interest of petitioner Fred T. Hogan is his separate income or community income to be divided between Fred T. Hogan and petitioner Novadean Hogan.

Petitioners Fred T. Hogan and Novadean Hogan abandoned error charged with respect to gain arising from the sale of another lease by them.

Findings of Fact

All the stipulated facts are hereby found accordingly. From the evidence adduced at the hearing further facts are found and those facts in the following recital, which are not from the stipulation, are found from the evidence adduced at the hearing.

Petitioners are all individuals. Lucille Choate is the wife of L. H. Choate and during the years 1936, 1937, and 1938, they were living together in Texas as husband and wife. Novadean Hogan is the wife of Fred T. Hogan. With the exception of W. G. Choate, the Federal tax returns for each of the petitioners for the year 1936 were filed with the collector of internal revenue at Dallas, Texas. W. G. Choate's return for 1936 was filed with the collector of internal revenue at Oklahoma City, Oklahoma.

On September 8, 1924, Mrs. N. L. Baker executed an oil and gas lease to C. A. Tunstill, covering, among other land, 230 acres located in Upton County, Texas. Under the terms of the lease the lessee had 10 years in which to produce oil or gas; on the production of oil or gas the term of the [fol. 26] lease was to be 50 years from the date of its execution. The lessor retained the customary one-eighth *roy* royalty interest, and was entitled to receive delay rentals on the lessee's failure to begin drilling operations within 12 months from the date of the *executuin* of the lease.

On July 7, 1925, Tunstill assigned the lease to the Marland Oil Company and on July 1, 1929, the lease became the property of the Continental Oil Company as the result of a consolidation of the two companies.

By an instrument dated December 3, 1936, the Continental Oil Company assigned to Roy R. Brown all its right, title, and interest in the lease in question "in so far as said lease covers and affects the oil, gas and *cacinghead* gas, and the oil, gas and *cacinghead* gas rights, at and above the *dept* of 2,750 feet from the surface in and under" the 230 acres. Brown assumed all the covenants of the original lease and further agreed that "as a part of the consideration for this assignment, the assignor shall receive, as an overriding royalty, one-sixteenth (1/16th) of all the oil, gas or *cacinghead* gas produced, saved and sold from the * * * land, from depths not exceeding 2750 feet from the surface." This lease will sometimes hereinafter be referred to as the Baker lease.

On December 18, 1936, petitioners Fred T. Hogan and L. H. Choate acquired Brown's interest in the Baker lease by assignment for a consideration of $5,000, $2,500, of which was to be paid in cash and the remaining $2,500 was payable out of one-eighth of the thirteen-sixteenths of all oil produced and saved from the property if, as, and when produced.

Fred T. Hogan and L. H. Choate, in acquiring the interest in the Baker lease from Brown were acting for themselves and W. G. Choate. After acquiring the interest in the Baker lease Hogan and L. H. Choate proceeded to organize a partnership known as "Choate & Hogan" of Midland, Texas, to own, develop and operate the Baker lease. The profits and losses of the partnerships were to be shared 50 per cent by Hogan and 50 per cent by L. H. Choate and W. G. Choate.

[fol. 27] In the conduct of the affairs of the partnership, Hogan had supervision of the geological work in connection with the drilling of the wells; he also attended to financial arrangements, the sales of oil produced from the lease and negotiated the sale of the lease itself. L. H. Choate was a drilling contractor who used his own equipment in drilling the wells on the lease. Hogan was dependent upon L. H. *Choat* for the drilling of the wells. This was the

reason for the formation of this partnership. W. G. Choate was a partner of L. H. Choate and performed no services on the lease.

In developing and operating the Baker lease the partnership drilled six wells. In order to finance the drilling of the wells they obtained loans from the Mercantile National Bank of Dallas, Texas, as follows:

Due Date	Description	Amount
6-15-37	Note #1, Baker Wells #1 and #2	$21,666.67
9- 2-37	Note #3, Baker Well #3	11,000.00
10- 7-37	Note #4, Baker Well #4	11,000.00
11- 6-37	Note #5, Baker Well #5	11,000.00
12- 4-37	Note #6, Baker Well #6	11,000.00
	Total Principal Sum	$65,666.67

The agreement under which these loans were made provided that the indebtedness should be liquidated from an assignment of oil runs from the Baker lease and the indebtedness was paid therefrom to the extent of $36,256.30. The balance of the indebtedness of $65,666.67 was paid on August 22, 1938, not out of oil runs but, in effect, out of the proceeds received by the partnership from the conveyance of an interest in the Baker lease to the Sylva Oil Company, to be *described* presently.

The Baker lease was owned and operated by the partnership until that conveyance which took place on August 22, 1938.

On August 11, 1938, the partnership entered into a written contract covering the Baker lease to the McAlester Fuel Company in which the partnership was designated as "seller" and the McAlester Fuel Company as "buyer". Under the contract the partnership was to execute and [fol. 28] deliver an assignment of the lease to the McAlester Fuel Company and that company was to "buy" the lease from the partnership for a consideration of $110,000 in cash, to be paid upon delivery of a proper assignment of the lease to the McAlester Fuel Company. The partnership was "to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8th of 8/8ths of all oil and gas produced" by the McAlester Fuel

Company, its successors or assigns. The reservation was to be one-sixteenth in the name of L. H. Choate and one-sixteenth in the name of Hogan.

By agreement between the parties the contract of purchase of the lease was to be carried out by execution of an instrument of conveyance to the Sylva Oil Company instead of to the McAlester Fuel Company.

On August 22, 1938, the Sylva Oil Company notified L. H. Choate that it had purchased the lease "together with the producing oil wells thereon and the equipment of such wells, including the house on the lease." This letter farther advised that it was understood that L. H. Choate had on the lease certain drilling equipment, pipe and a pick-up truck which it was choate's privilege to remove since the Sylva Oil Company was "only acquiring the personal property actually used and attached to such producing wells on the lease," and the above-mentioned house.

On the same date, August 22, 1936, Choate & Hogan executed an instrument by which they did "bargain, sell, assign and convey" the Baker lease subject to all the terms of the instrument under which it was acquired by the partnership, all of its right, title and interest in the property "together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage, to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignor herein expressly reserve to themselves, their heirs and assigns, and do not assign or convey to the assignee herein, 1/8 of the 8/8ths of all oil and gas and casinghead gas which may be produced and saved by [fol. 29] Sylva Oil Company its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred fifty feet from the surface under and by virtue of the lease above mentioned, delivery of such part of the oil, gas and casinghead gas to be made free of cost to the assignors * * *; such reservation of overriding royalty or share of production to be 1/16th of the 8/8ths in favor of L. H. Choate, and 1/16th of the 8/8ths in favor of Fred T. Hogan."

At the date of the transaction with Sylva Oil Company the interest in the Baker lease owned by Choate and Hogan

consisted of thirteen-sixteenths of eight-eighths, the $2,500 oil payment reserved by Roy R. Brown having been paid out during March, 1938, and the cost, less depletion sustained, of this interest to the partnership was $23,583.78 on that date.

On the date of the transaction the cost of the equipment on the lease, less depreciation sustained, was $23,090.60.

After the *assignment*, Sylva Oil Company drilled and paid for four additional oil wells and operated the lease, and the parties otherwise conformed to the terms of the instrument. Neither the Choates nor Hogan understood that they had any rights as landlord. Sylva Oil Company certified and guaranteed to Humble Oil Company that effective 7:00 A. M. on August 15, 1938 (the effective date of the last transaction) it was the legal owner of a seven-eighths interest in the oil produced from the property covered by the Baker lease subject to overriding royalties of one-sixteenth each to Continental, L. H. Choate and Hogan.

Sylva Oil Company allocated the $110,000 purchase price as follows:

Leasehold costs, $46,500; equipment of six wells, $24,000; additional equipment and gun barrel, $2,500; drilling cost of six wells, $36,000; dwelling on the lease, $1,000. It claimed depreciation on the cost thus allocated to equipment in its return for the year 1938 in the amount of $1,674.17 and in its income tax return for 1939 in the amount of $5,613.35 which amounts were allowed to it for those [fol. 30] years as depreciation on the equipment by the Commissioner of Internal Revenue after an examination by his agent. Sylva Oil Company assessed the leasehold interest which it acquired and all the equipment thereon for ad valorem taxes in the State of Texas and County of Upton and paid the taxes based on such assessment. Sylva Oil Company also made all repairs and replacements to the equipment after August 22, 1938, and paid for all such repairs and replacements.

The transaction involved was reported in the partnership return of Choate and Hogan for the year 1938 as a sale as follows:

	Leasehold	Equipment	Total
Sale Price	$98,454.70	$11,545.30	$110,000.00
Less Cost of Sale:			
Gross Cost	$33,391.80	$30,206.49	$63,598.29
Less-Reserves for Depletion and Depreciation	9,808.02	7,115.89	16,923.91
Net Cost of Sale	$23,583.78	$23,090.60	$46,574.38
Gross Gain from Sale	$74,870.92	($11,545.30)	$63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	($11,545.30)	$60,325.62
Taxable Gain from Sale (Sec. 117. Revenue Act of 1938)	$47,913.95	($11,545.30)	$36,368.65

The loss of $11,545.30 as above computed on the sale of equipment was reported as an ordinary loss. The net gain from the sale of the leasehold of $71,870.92 was reported as a long-term capital gain, under section 117, Revenue Act of 1938, taxable to the extent of $47,913.95.

The above gain of $47,913.95 and loss of $11,545.30 were reported in the individual returns of the partners as follows:

[fol. 31]		Gain	Loss
Fred T. Hogan	1/2	$23,956.98	$ 5,772.65
Novadean Hogan		None	None
L. H. Choate	1/8	5,989.24	1,443.16
Lucille Choate	1/8	5,989.24	1,443.16
W. G. Choate	1/4	11,978.49	2,836.33
		$47,913.95	$11,545.30

In his notice of deficiency respondent determined that the partnership did not make a sale of the Baker lease but held that the transaction constituted a sublease, the

consideration of $110,000 being a bonus. Respondent computed the gain on the transaction as follows:

Oil Income		$110,000.00
Less—Depletion	$30,250.00	
Commissions	3,000.00	33,250.00
		$ 76,750.00

Fred T. Hogan and Novadean Hogan were married in Arizona on September 6, 1937, and from the date to the present time have lived together as husband and wife in Texas. At the time of their marriage three wells had been drilled by the partnership on the lease and prior to the time the lease was sold to the Sylva Oil Company three additional wells were drilled. As heretofore indicated, Hogan did the geological work together with general management and arranged for financing and for the ultimate sale of the lease. Prior to their marriage Novadean worked for the partnership in its office at Midland, Texas. She handled the correspondence and prepared monthly reports required by the railroad commission and others. She performed the general office work in connection with the acquisition, development and operation of the lease by the partnership. After their marriage she continued to perform these duties and was paid a salary by the partnership. She also did work for L. H. Choate in connection with drilling for outsiders for which she was not paid any additional salary.

[fol. 32] The cost of the wells incurred by the partnership allocated to the periods before and after marriage were as follows:

Before marriage	$25,762.03
After marriage	39,141.80
Total	$64,903.83

Runs from the Baker lease were to be paid over to the bank and applied on the indebtedness. An assignment of such oil runs was given by the partnership to the bank. The oil runs from the lease used to apply on the indebtedness, segregated between production before and after marriage were as follows:

Before marriage	$ 1,056.85
After marriage	$35,199.45
Total	$36,256.30

Total production from the interest in the Baker lease owned by the partnership during the period of ownership *amounted* to $39,265.50, being $4,066.05 from production before the marriage and $35,199.45 after the marriage.

OPINION

That petitioners were not entitled to treat the transfer of an interest in these leases as a sale, but must look to depletion for the return of their capital, is sufficiently clear to require but little demonstration. Where a royalty *interest* is retained, as was the case here, the *principle* of recovery by depletion rather than by treatment as a sale applies to all receipts, including any cash bonus which is regarded as in the nature of advance royalties. Cullen v. Commissioner (C.C.A., 5th Cir.), 118 Fed. (2d) 651; McLean v. Commissioner (C.C.A., 5th Cir.) 120 Fed. (2d) 942.

The authority of these cases has not been weakened by Le v. Commissioner (C.C.A., 5th Cir.), 126 Fed. (2d) 825. Its effect was merely to repudiate the distinction originally drawn in Commissioner v. Laird. (C.C.A., 5th Cir.), 91 Fed. (2d) 498, between royalty and oil-payment cases as to recovery of initial cost. If this were an oil payment case which it is not, and if the *Lee* case had not been decided, [fol. 33] petitioners might be in a position to seek to limit the taxability of the cash received to the excess over their original investment on the theory of the Laird case. Cf. Columbia Oil and Gas Co. v. Commissioner (C. C. A., 5th Cir.) 118 Fed (2d) 459. But we are at a loss to see that petitioners can take any comfort from the *Lee* case under the circumstances existing here. This issue is decided for respondent.

What gives us the greatest difficulty is a sentance in Cullen v. Commissioner, supra, to the effect that "the cost of equipment * * * may be recovered by percentage depletion allowance." It is by no means clear that the court intended there to hold that tangible physical equip-

ment used in the operation of leases transferred upon a retained royalty was subject to recovery through depletion rather than through depreciation on the one hand or from the proceeds of the sale on the other. Even, however, if that were the intention, the present facts are distinguishable from those in the Cullen case. The contracts there made no mention of the physical equipment, and it might have been assumed that the transfer intended to retain the tangible property or an interest therein, at least to the same extent as with respect to the oil itself.

Here the assignment not only contained specific reference to the tangible equipment but seems to require the construction that all of petitioner's interest for all time and for all purposes was thereby transferred to the assignee. Cf. Columbia Oil and Gas Co. v. Commissioner, supra. If that is the proper construction of the contract, petitioner would have no further claim to depreciation on the equipment, cf. Regulations 101, Article 23, (a) 18, and its unrecovered cost could be secured only by allocating to the equipment some portion of the purchase price, which the petitioners here seem to have done or, in the alternative, by deducting the difference as a loss. Without being assured as to the meaning of the quotation from the Cullen case, we are nevertheless satisfied that it is in any event inapplicable here, and conclude that petitioners are entitled to an allowance for the unrecovered cost of the equipment transferred.

[fol. 34] The final issue with respect to petitioner, Fred T. Hogan, involves the claim that the proceeds of the assignment were community income. The leases in question were acquired prior to his marriage, and it must be recognized that ordinarily the proceeds of such a transaction as we have here would be regarded as an increase in lands owned by petitioner prior to his marriage, and hence his separate income. Commissioner v. Wilson (C. C. A., 5th Cir.), 76 Fed. (2d) 766; Turhaville v. Commissioner. (C. C. A., 5th Cir.), 84 Fed. (2) 307.

It is asserted, however, that in this instance the profit was made possible by the intermediate development of the oil property which took place to a preponderant extent subsequent to the marriage; and further, that some of the income from the lease, admittedly belonging to the community, was used to finance such development. We

are not convinced that either consideration is sufficient to authorize an exception in this case. The interest which was transferred and for which the payment was received was in the leases themselves. It was not compensation for the services of the husband. Nor is it clear that his personal activities in designating the location of the wells, as distinguished from the actual drilling which was performed by others, added materially to the value of the property. See Commissioner v. Turbeville, supra. And certainly, the use of community funds with or without the approval of the wife could do no more than possibly create an indebtedness. None of the considerations advanced by petitioner were sufficient to transform separate property into community income. E. Michas, 24 B. T. A. 715.

Decision will be entered under Rule 50.

Entered: December 9, 1942.

In the Tax Court of the United States

Decision—Feb. 12, 1943

Respondent having on January 5, 1943, filed a computation as in accordance with the memorandum findings of fact and opinion of the Court, entered herein December 9, 1942, and petitioner having on January 30, 1943, filed a recomputation in opposition thereto, and this proceed-[fol. 35] ing having been called from the Day Calendar for hearing on February 10, 1943, at Washington, D. C., pursuant to notice, at which time respondent agreed to petitioner's computation, now, therefore, it is

Ordered and decided: That there is a deficiency in income tax for the year 1938 in the amount of $1,052.07.

Clarence V. Opper, Judge. (Seal.)

Enter:

Entered February 12, 1943.

In United States Circuit Court of Appeals

Petition for Review—Filed May 1, 1943

To the Honorable Judges of Said Court:

Now comes the petitioner, W. G. Choate, by his attorney, James H. Yeatman (Vinson, Elkins, Weems & Francis)

and files this his petition for review by the United States Circuit Court of Appeals for the Tenth Circuit of the decision of the Tax Court of the United States entered February 12, 1943.

Jurisdiction

The petitioner is an individual and his residence and place of business is at Cisco, Texas. Petitioner's return for the calendar year 1938, the year in controversy, was filed with the Collector of Internal Revenue at Oklahoma City, Oklahoma, which is within the Tenth Judicial District of the United States. On March 20, 1941, the respondent in accordance with Section 272 (a) of the Internal Revenue Code, advised the petitioner by registered mail that a determination of his income tax liability for the year ended December 31, 1938, disclosed a deficiency of $2,015.58. Thereafter the petitioner duly filed with the then United States Board of Tax Appeals (now the Tax Court of the United States) a petition for redetermination of the deficiency disclosed in the respondent's said letter of March 20, 1941, and respondent duly filed an answer to the said petition. The proceeding was heard by the United States Board of Tax Appeals on May 5, 1942, and was submitted on a stipulation of facts, documentary evidence and oral [fol. 36] testimony. On February 12, 1943, the Tax Court of the United States entered its decision that there is a deficiency in petitioner's income tax liability for the calendar year 1938 in the amount of $1,052.07. The jurisdiction of this Court is invoked under Section 1141 of the Internal Revenue Code.

Nature of the Controversy

The controversy between the parties is whether certain income received by petitioner was gain from the sale or exchange of a capital asset. The facts are that on December 18, 1936, Fred T. Hogan acting for himself and L. H. Choate and W. G. Choate purchased an oil and gas lease from Roy R. Brown. Said lease was known as the Baker lease and covered a tract of land located in Upton County, Texas. Immediately after said lease was acquired a partnership known as Choate & Hogan was formed to own, develop and operate it and it was agreed that the profits and losses of the partnership would be shared 50% by petitioner and L. H. Choate and 50% by Fred T. Hogan. The part-

nership developed the Baker lease by drilling six producing oil wells thereon and operated it until August 22, 1938. On August 11, 1938, L. H. Choate and Fred T. Hogan acting for the partnership entered into a written contract to sell the Baker lease, together with all of the equipment thereon, to the McAlester Fuel Company. The consideration to be paid by the McAlester Fuel Company was $110,000.00 in cash and the sellers were to except and reserve to themselves an overriding royalty of one-eighth. Said contract was consummated and carried out according to its terms by L. H. Choate and Fred T. Hogan on August 22, 1938, executing an assignment of the lease to the Sylva Oil Company, nominee of the McAlester Fuel Company, and the Sylva Oil Company paying the agreed consideration of $110,000.00. The petitioner unsuccessfully contended before the Court below that an interest in the Baker lease was sold to the Sylva Oil Company and that the net proceeds derived from the sale was taxable as long-term capital gain under Section 117 of the Code. With respect to the leasehold itself the Court below held that the transaction was a sublease of the lease rather than a sale; that the consideration received therefor was a bonus, [fol. 37] subject to the allowance for depletion, and not gain derived from the sale or exchange of capital asset.

Designation of Court of Review

The petitioner being aggrieved by the conclusions of law contained in the opinion of the Tax Court of the United States in its memorandum opinion promulgated December 9, 1942, and by the final decision entered by it on February 12, 1943, pursuant to said opinion, desires to obtain a review thereof by the United States Circuit Court of Appeals for the Tenth Circuit.

Assignments of Error

The petitioner's assignments of error are as follows:

I

The Tax Court of the United States erred in failing to find and decide that petitioner and his co-owners sold to the Sylva Oil Company all of their interest in the Baker leasehold estate save and except the one-eighth overriding

royalty retained and in failing to find and decide that the profit realized on the transaction was gain from the sale or exchange of a capital asset within the meaning of Section 117 of the Internal Revenue Code.

II

The Tax Court of the United States erred in finding and deciding that petitioner and his co-owners subleased their Baker leasehold estate to the Sylva Oil Company and in finding and deciding that the transaction with the Sylva Oil Company was not a sale of a capital asset within the purview of Section 117 of the Internal Revenue Code.

Wherefore, petitioner prays that this Honorable Court may review said findings, opinion and decision of the Tax Court of the United States and set aside same in so far as it was held therein that petitioner and his co-owners did not sell an interest in the Baker leasehold estate and that the gain realized thereon was not gain from the sale or exchange of a capital asset and that this Court direct entry of a decision by the said Tax Court of the United States in favor of petitioner on the above said lease.
[fol. 38] Petitioner prays for such relief as he is entitled to receive, and prays that the Clerk of the Tax Court of the United States be directed to transmit and deliver to the Clerk of this Honorable Court certified copies of all documents material for the presentation of the foregoing petition for review as required by the Rules of this Honorable Court and by the statutes made and provided, and petitioner prays for such other and further relief as is mete and proper in the premises.

W. G. Choate, Petitioner, By James H. Yeatman, Counsel for Petitioner, 11th Floor Esperson Bldg., Houston, Texas.

Duly verified by James H. Yeatman.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

TAXPAYER'S STATEMENT OF POINTS—Filed July 5, 1943

The point relied on by taxpayer is that the transaction whereby the partnership of Choate and Hogan, of which

taxpayer was a member, disposed of an interest in an oil and gas lease, was a sale, and not a sublease, as held by the Tax Court, and that the profit realized thereon was long term capital gain, as defined by Section 11 of the Internal Revenue Code.

James H. Yeatman, Niels Esperson Bldg., Houston, Texas, Attorney for Petitioner on Review.

[fol. 39] In United States Circuit Court of Appeals

Petition for Review—Filed May 3, 1943

Guy T. Helvering, United States Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Tenth Circuit to review the decision entered by the Tax Court of the United States on February 12, 1943, that there is a deficiency in income tax for the year 1938 in the amount of $1,052.07. The respondent on review, W. G. Choate, filed his Federal income tax return for the calendar year 1938, the taxable year here involved, with the Collector of Internal Revenue for the District of Oklahoma, whose office is located at Oklahoma City, Oklahoma, and within the judicial circuit of the United States Circuit Court of Appeals for the Tenth Circuit. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

Samuel O. Clark, Jr., Assistant Attorney General; J. P. Wenchel, RLW, Chief Counsel, Bureau of Internal Revenue.

In the United States Circuit Court of Appeals

Commissioner's Statement of Points—Filed July 6, 1943

Now comes Guy T. Helvering, Commissioner of Internal Revenue, the petitioner on review herein, by and through his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, and J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and hereby states that he intends to rely upon the following points in this proceeding:

The Tax Court of the United States erred:

1. In ordering and deciding that there is a deficiency in income tax for the year 1938 in the amount of only $1,052.07.

2. In failing and refusing to sustain the deficiency in tax determined by the Commissioner.

3. In holding and deciding that in the determination of the profit or loss from the transfer of the taxpayer's inter- [fol. 40] est in the Baker oil and gas lease, the taxpayer is entitled "to an allowance for the unrecovered cost of the equipment transferred," in the taxable year 1938.

4. In failing and refusing to hold and decide that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease in the taxable year 1938, the taxpayer is not entitled to deduct the undepreciated cost of the equipment from the cash proceeds received upon the conveyance of such interest.

5. In failing and refusing to hold and decide that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease in the taxable year 1938, the undepreciated cost of the equipment should be recovered, for income tax purposes, through depletion allowances in the same manner as it (The Tax Court) held that the unrecovered leasehold cost should be recovered.

6. In failing and refusing to hold and decide that where, as in the present case, a leasehold interest is transferred and conveyed for a cash bonus and a retained royalty interest, the taxpayer's unrecovered capital investment in the leasehold so transferred and in the tangible physical equipment thereon should both be recovered through depletion allowances.

7. In that its holding and decision that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease, the taxpayer is entitled "to an allowance for the unrecovered cost of the equipment transferred" to be deducted from the cash bonus is not supported by but is contrary to the facts as found by the Tax Court.

8. In that its holding and decision that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease, the taxpayer is entitled "to an allowance for the unrecovered cost of the [fol. 41] equipment transferred" to be deducted from the

cash bonus is not supported by the evidence and is contrary to law.

Samuel O. Clark, Jr., C A R, Assistant Attorney General; J. P. Wenchel, CAR, Chief Counsel, Bureau of Internal Revenue.

Statement of Service:

A copy of this statement of points was mailed to James H. Yeatman, Esq., Niels Esperson Bldg., Houston, Texas, attorney for respondent on review this date, July 6, 1943.

Chas. E. Lowery, Special Attorney.

IN THE TAX COURT OF THE UNITED STATES

ORDER ENLARGING TIME TO DOCKET PETITION

Upon motion of counsel for petitioner, it is

Ordered: that the time for preparation, transmission and delivery of the record sur petition for review of the above-entitled proceeding in the United States Circuit Court of Appeals for the Tenth Circuit is extended to July 30, 1943.

J. E. Murdock, Presiding Judge.

Dated: Washington, D. C., June 7, 1943.

Filed July 29, 1943. Robert B. Cartwright, Clerk.

Clerk's Certificate to foregoing order omitted in printing.

[fol. 42] IN THE TAX COURT OF THE UNITED STATES

ORDER ENLARGING TIME TO DOCKET PETITION

Upon motion of counsel for petitioner, it is

Ordered: that the time for preparation, transmission and delivery of the record sur petition for review of the above-entitled proceeding in the United States Circuit Court of Appeals for the Tenth Circuit is extended to July 31, 1943.

J. E. Murdock, Presiding Judge.

Dated: Washington, D. C., May 22, 1943.
Filed July 29, 1943. Robert B. Cartwright, Clerk.

Clerk's Certificate to foregoing order omitted in printing.

IN THE TAX COURT OF THE UNITED STATES

AGREED STATEMENT OF FACTS

It is stipulated and agreed by and between the parties hereto, acting through their attorneys, that the above styled proceedings may be consolidated for the purpose of hearing, and it is further stipulated and agreed that the following facts are true and may be so found by this Board, subject to the right of either party to offer other evidence not inconsistent with the facts so stipulated.

1

All of the Petitioners are individuals. Mrs. Lucille Choate is the wife of L. H. Choate, and during the years 1936, 1937, and 1938 they were living together in Texas as husband and wife. Novadean Hogan is the wife of Fred T. Hogan. Novadean Hogan and Fred T. Hogan were married in the State of Arizona, September 6, 1937, and since such date to the present time they have continuously lived together as husband and wife in the State of Texas. With the exception of that of W. G. Choate, the Federal Income Tax Returns of each of the Petitioners for the year 1938 were filed with the Collector of Internal Revenue at Dallas, [fol. 43] Texas. Dr. W. G. Choate resided in Oklahoma during 1938, and his return for that year was filed with the Collector of Internal Revenue at Oklahoma City, Oklahoma.

2

On December 3, 1936, the Continental Oil Company, of Ponca City, Oklahoma assigned to Roy R. Brown, of Amarillo, Texas, an interest in an oil and gas lease covering approximately 230 acres of land situated in Upton County, Texas. A true copy of this assignment is attached to the petition in each case as Exhibit "B" and is made a part hereof. This lease will be hereinafter referred to as the Baker lease.

3

On December 18, 1936, Petitioners Fred T. Hogan and L. H. Coate, acting for themselves and for Dr. W. G. Choate, acquired an interest in the Baker lease by assignment from Roy R. Brown. A true copy of said assignment is attached to the petition in each case as Exhibit "C."

4

The consideration paid by Choate & Hogan for the interest in the Baker lease was $5000.00, $2500.00 of which was paid in cash and the balance, $2500.00, was payable out of 1/8 of 13/16 of the oil to be produced therefrom, if, as and when produced.

5

After acquiring the interest in the Baker lease, Fred T. Hogan and L. H. Choate proceeded to organize a partnership known as "Choate & Hogan" of Midland, Texas. It was understood and agreed that the partnership of Choate & Hogan would own, develop and operate the Baker lease and that the profits and losses therefrom would be shared as follows:

[fol. 44] 6

L. H. Choate and Dr. W. G. Choate:	50%
Fred T. Hogan:	50%

The partnership of Choate & Hogan thereupon proceeded to develop and operate the Baker lease until August 22, 1938. On August 22, 1938, L. H. Choate and Fred T. Hogan entered into a transaction with the Sylva Oil Company, a Texas corporation. This transaction was evidenced by a written instrument, copy of which is attached to the petition in each case as Exhibit "D" and is made a part hereof. The consideration running from the Sylva

Oil Company to Choate & Hogan on account of said transaction was $110,000.00 cash. At the time this transaction was made there were six producing oil wells on the Baker lease, all of which had been drilled and operated by the partnership of Choate & Hogan.

7

The transaction between L. H. Choate and Fred T. Hogan and the Sylva Oil Company of August 22, 1938, was reported in the partnership return of Choate & Hogan for the year 1938 as a sale, as follows:

	Leasehold	Equipment	Total
Sale Price	$98,454.70	$11.545.30	$110,000.00
Less Cost of Sale:			
Gross Cost	$33,391,80	$30,206.49	$ 63,598.29
Less Reserves for Depletion & Depreciation	9,908.02	7,115.89	16,923.91
Net cost of Sale	$23,583.78	$23,090.60	$ 46,674.38
Gross Gain from Sale	$74,870.92	($11,545.30)	$ 63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	($11,545.30)	$ 60,325.62
Taxable Gain from Sale (Section 117, Revenue Act of 1938	$47,913.95*	($11,545.30)	$ 36,368.65

* This was reported as an ordinary loss.

[fol. 45] The above gain of $47,913.95 and the loss of $11,545.30 were reported in the individual returns of the partners as follows:

		Gain	Loss
Fred T. Hogan	½	$23,956.98	$ 5,772.65
Novadean Hogan		None	None
L. H. Choate	⅛	5,989.24	1,443.16
Lucille Choate	⅛	5,989.24	1,443.16
Dr W. G. Choate	¼	11,978.49	2,836.33
		$47,913.95	$11,545.30

9

It is agreed between the parties hereto that at the date the transaction with Sylva Oil Company occurred the cost, less repletion sustained, of the Baker leasehold-interest to the partnership of Choate & Hogan was $23,583.78 and that the cost of the equipment on the lease, less depreciation sustained, was $23,090.60. If the Board determines that the transaction constitutes a sale of an interest in the Baker leasehold estate, together with the equipment thereon, it is agreed that the profit and loss thereon were correctly reported in the partnership return as indicated in paragraph 7 hereof.

10

In the notice of deficiency on which these proceedings are based, the Respondent determined that Choate & Hogan did not make a sale of the Baker lease. Respondent held that the transaction constituted a sub-lease and that the consideration of $110,000.00 was a bonus and he computed the gain on the transaction as follows:

"Oil Income"		$110,000.00
Less—Depletion	$30,250.00	
Commission	3,000.00	33,250.00
Net Income		$ 76,750.00

[fol. 46] 11

It is agreed that the following statement shows the income from the operation of the Baker lease from April, 1937, to and including August, 1938, and the amounts received by Roy R. Brown on the oil payment reserved:

		Choate & Hogan's Interest		Oil Payment (Roy Brown's Interest)	
		Before Marriage of Fred T. Hogan	After Marriage of Fred T. Hogan	Before Marriage of Fred T. Hogan	After Marriage of Fred T. Hogan
Pipe Line Runs					
1937	April	$ 497.82		$ 71.11	
	May	796.85		113.84	
	June	1,054.81		150.69	
	July	659.72		94.25	
	Aug.	1,056.85		150.93	
	Sept.		$ 1,282.10		$ 183.15
	Oct.		1,571.34		224.48
	Nov.		1,888.54		269.79
	Dec.		2,227.58		318.22
1938					
	Jan.		2,571.08		367.30
	Feb.		2,921.19		417.31
	Mar.		3,532.27		138.88
	Apr.		4,100.64		
	May		4,035.49		
	June		3,621.22		
	July		3,387.74		
	Aug.		4,060.26		
		$4,066.05	$35,199.45	$580.87	$1,919.13

12

In order to finance the development of the Baker lease, the partnership of Choate & Hogan negotiated loans with the Mercantile National Bank of Dallas, Texas, as follows:

[fol. 47]

Due Date	Description	Amount
6-15-37	Note #1, Baker Wells #1 & #2	$21,666.67
9- 2-37	Note #3, Baker Well #3	11,000.00
10- 7-37	Note #4, Baker Well #4	11,000.00
11- 6-37	Note #5, Baker Well #5	11,000.00
12- 4-37	Note #6, Baker Well #6	11,000.00
	Total Principal Sum	$65,666.67
	Add Interest	2,886.06
	Total	$68,552.73

13

The loan agreement with the Mercantile National Bank of Dallas provided that the indebtedness should be liquidated from an assignment of the oil runs from the Baker lease, and, accordingly, such indebtedness was paid as follows: –

Oil Runs Assigned to Bank	Before Marriage of Fred T. Hogan	After Marriage of Fred T. Hogan
1937—August	$1,056.85	$
September		1,282.10
October		1,571.34
November		1,888.54
December		2,227.58
1938—January		2,571.08
February		2,921.19
March		3,532.27
April		4,100.64
May		4,035.49
June		3,621.22
July		3,387.74
August		4,060.28
Totals	$1,056.85	$35,199.45
Balance Paid Aug. 22, 1938		32,296.43
Totals	$1,056.85	$67,495.88

Oil and gas wells were drilled on the Baker lease by the partnership of Choate & Hogan as follows:

Well No.	Completion Date	Cost Marriage Before Fred T. Hogan	After Fred T. Hogan
#1	3- 5-37	$12,238.73	$
#2	4-30-37	13,523.30	
#3	9- 1-37		13,098.49
#4	10- 5-37		8,918.06
#5	11- 1-37		8,573.13
#6	12- 2-37		8,552.12
	Totals	$25,762.03	$39,141.80

James H. Yeatman, Counsel for Petitioners. J. P. Wenchel, JLB, Counsel for Respondent.

* * * * * * *

[fol. 69] PETITIONER'S EXHIBIT 7

Contract

STATE OF TEXAS,
County of Midland:

This Agreement entered into this the 11th day of August A. D. 1938 by and between Choate and Hogan, a co-partnership composed of L. H. Choate and Fred T. Hogan, hereinafter refered to as "Seller" and The McAlester Fuel Company, a Delaware Corporation, hereinafter referred to as "Buyer."

Witnesseth: The said Seller represents that it is the owner of an Oil and Gas Lease covering a part of Survey Number Seven (#7), Block R, Certificate No. 563, Confederate Script, M. S. Denton, Grantee, located in Upton County, Texas, said lands being described by metes and bounds, as follows:

Beginning at a stake, the east corner of a survey of 1280 acres in the name of E. C. Grooms, same being the North corner of Survey No. 7, Block "R", M. S. Denton;

Thence S 50 deg. E 1122.4 varas to the most northerly southeast corner of this tract;

Thence S 40 *deg.* W 257.6 varas to the most easterly inside corner of this tract;

Thence S 50 deg. E 237.6 varas to the most southerly southeast corner of this tract;

Thence S 40 deg. W 418.4 varas to the east corner of a tract of land containing 80 acres assigned by Continental to Chas. L. Morgan by instrument dated November 13, 1925;

Thence N 50 deg. W with the NE B. L. of said Morgan tract 672 varas to its north corner;

Thence S 40 deg. W with the NW B. L. of said Morgan tract 672 varas to its north corner;

Thence N 50 deg. W 688 varas to a point in the NW B. L. of Survey No. 7, Block "R", M. S. Denton, the most westerly corner of this tract;

[fol. 70] Thence N 40 deg. E 1528 varas with the NW B. L. of said Survey No. 7 to place of beginning, containing 230 acres of land, more or less.

Said original lease being recorded in Volume 18, Page 523 of the Oil and Gas Lease Records of Upton County, Texas; said lease held by Seller being by reason of an Assignment from Continental Oil Company, a Delaware Corporation, and down to a depth of 2750' from the surface, all minerals under said depth being reserved by the Continental Oil Company; and the said Continental Oil Company likewise reserved and excepted an overriding royalty of 1/16th of the 8/8ths production, all as shown by such Assignment of Oil and Gas Lease, dated day of , 19 , recorded in Volume , Page of the Deeds Records of Upton County and here now referred to and made a part hereof for all purposes.

The Seller proposes to execute and deliver an Assignment of such Oil and Gas Lease, hereinabove described, to Buyer, subject to the terms and conditions of such Assignment from the Continental Oil Company, and Buyer agrees to buy from Seller such Oil and Gas Lease, all upon the following terms and conditions:

(1) Seller agrees to furnish an Abst*ar*ct of Title certified down to this date, same to be furnished within five (5) days from this date and deliver same to Buyer; Buyer is to have ten (10) days from the date of delivery of such abstract in which to have same examined and to point out objections,

if any there are thereto, in writing; such written objections to be delivered to Seller in Midland, Texas, within said period of ten (10) days; Seller is to have five (5) days after receipt of written objections in which to cure the same and if such objections are not cured within the said period of five (5) days then Buyer is to have five (5) days thereafter in which to accept or reject title in its then condition.

(2) If this deal is consummated and the Assignment delivered, then Buyer is to have all oil runs from and after August 15th, 1938, at 7:00 o'clock A. M., less only actual operating costs after said date, and oil override.

[fol. 71] (3) Seller is to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8 of 8/8ths of all oil and gas produced and saved from same by Buyer, its successors or assigns; such reservation in the Assignment to be executed and delivered, to be 1/16th of the 8/8ths in the name of L. H. Choate and 1/16th of the 8/8ths in the name of Fred T. Hogan.

(4) It is further agreed by the parties hereto that in the event of this purchase being completed and proper assignment delivered to Buyer, that Buyer will, with reasonable diligence, begin the drilling of a well, prospecting for oil and gas, on some part of said property and drill same with due and reasonable diligence to completion, and further agrees that it will continue development of said property, after drilling of said first well, with due and reasonable diligence until such time that the property is reasonably developed; the obligation on Buyer to so drill such property is subject only to such valid spacing and proration rules and regulations as may be imposed by the proper authorities, and the future happening of conditions which would cause a reasonably prudent operator to refrain from drilling additional wells.

(5) It is further agreed between the parties hereto that should the Buyer, its successors or assigns, decide at any time to abandon or sell any depleted well, drilled on said lease, that Seller, their heirs, successors or assigns, shall have the refusal to purchase such well at the highest bona fide offer Buyer may have received for the same; any such well to carry with it ten (10) acres around it, in as near the form of a square as practicable. Seller will be required

to exercise their right to purchase well under such conditions within five (5) days after the same is offered.

(6) The consideration to be paid Seller by Buyer is the sum of One Hundred Ten Thousand Dollars ($110,000.00) in cash, upon the delivery of proper assignment of Oil and Gas Lease, conditioned as hereinabove set out and subject to all of the terms and conditions of the contract of assignment from Continental Oil Company, hereinabove referred to.

[fol. 72] (7) Seller represents that it is indebted to The Mercantile National Bank of Dallas, Texas, and that the money necessary to liquidate said debt is to be paid out of the $110,000.00 cash consideration and Buyer is authorized and instructed to pay such amount out of said $110,000.00 which may be necessary to liquidate said indebtedness to The Mercantile National Bank of Dallas, Texas, and a Release of the Lien will be delivered by said bank.

(8) Upon approval and acceptance of title the Seller agrees to execute and deliver to Buyer the proper Assignment of such Oil and Gas Lease as hereinabove provided with express covenants of general warranty;

(9) It is agreed that Buyer is under no obligation to pay any commission to any person by reason of this agreement and transaction, A. W. Cherry being the only agent in the matter and the commission to him is to be paid by Seller.

(10) This Agreement shall extend to and be binding upon the heirs, successors and assigns of the respective parties hereto.

Executed in duplicate this the 11th day of August A. D. 1938.

Choate and Hogan, by L. H. Choate, by Fred T. Hogan, "Seller"; The McAlester Fuel Company, by R. G. Lawton, "Buyer" Agent.

STATE OF TEXAS,
County of Midland:

Before me, the undersigned, a Notary Public in and for said County and State, on this day personally appeared L. H. Choate and Fred T. Hogan, known to me to be the persons whose names are subscribed to the foregoing in-

strument, and acknowledged to me that they executed the same for the purpose and consideration therein expressed. Given Under My Hand and Seal of Office this the 11th day of August A. D. 1938. Roy A. Minear, Notary Public in and for Midland County, Texas. (Seal.)

[fols. 73-75] STATE OF TEXAS,
County of Midland:

Before me, the undersigned, a Notary Public in and for said County and State, on this day personally appeared R. G. Lawton, agent for The McAlester Fuel Company, known to me to be the person and officer whose name is subscribed to the foregoing instrument and acknowledged to me that the same was the act of the said The McAlester Fuel Company, a Delaware Corporation, and that he executed the same as the act of such corporation for the purpose and consideration therein expressed, and in the capacity therein stated. Given Under My Hand and Seal of Office this the 11th day of August A. D. 1938. Roy A. Minear, Notary Public in and for Midland County, Texas. (Seal.)

PETITIONER'S EXHIBIT 8

August 22, 1938.

Messrs. L. H. Choate and Fred T. Hogan, Midland, Texas.

GENTLEMEN:

Referring to the contract of purchase executed by The McAlester Fuel Company with you under date of August 11, 1938: Please carry out this contract of purchase by execution of instrument of conveyance to Sylva Oil Company instead of to The McAlester Fuel Company.

Yours very truly, The McAlester Fuel Company, by
J. G. Puterbaugh, President.

[fol. 76] IN THE TAX COURT OF THE UNITED STATES

DOCKET ENTRIES

1941

Jun. 16—Petition received and filed. Taxpayer notified. (Fee paid).

1941

Jun. 16—Copy of petition served on General Counsel.

Aug. 5—Answer filed by General Counsel.

Aug. 5—Request for hearing in Dallas Texas filed by General Counsel.

Aug. 9—Notice issued placing proceeding on Dallas Texas calendar. Service of answer and request made.

1942

Mar. 25—Hearing set May 4, 1942 in Dallas Texas.

May 5—Hearing had before Mr. Opper—on the merits—submitted—Motion of counsel to consolidate. Granted. Motion of petitioners to amend petition in docket 107630-107886-7-8, Granted. Motion to amend and amended petitions filed in 107630-107886-7-8. Oral answers to amended petitions in dockets 107630-107886-7-8. Appearance of James H. Yeatman and Claude Collard, Agreed statement of facts all filed at hearing. Briefs due July 6, 1942. Reply briefs July 21, 1942.

May 16—Transcript of hearing 5-5-42 filed.

Jul. 3—Brief filed by General Counsel.

Jul. 6—Motion for extension of time to Aug. 6, 1942 to file brief filed by taxpayer 7-6-42. Granted.

Aug. 3—Brief filed by taxpayer 8-3-42. Copy served on General Counsel.

Dec. 9—Memorandum findings of fact and opinion rendered. Opper, Judge. Decision will be entered under Rule 50. Copies served 12-9-42.

1943

Jan. 5—Computation of deficiency filed by General Counsel.

Jan. 7—Hearing set Feb. 10, 1943 on settlement.

[fol. 77]

Jan. 30—Computation of deficiency filed by taxpayer. 2-3-43. Copy served on General Counsel.

Feb. 10—Hearing had before Judge Murdock on settlement under Rule 50. Respondent agrees to petioner's computation. Referred to Judge Opper for decision.

Feb. 12—Decision entered. Clarence V. Opper, #14.

Apr. 29—Motion for leave to file motion for amendment of findings of fact—motion for amendment lodged, filed by taxpayer.

1943

May 1—Petition for review by U. S. Circuit Court of Appeals, 10th Circuit, with assignments of error filed by taxpayer.

May 3—Petition for review by U. S. Circuit Court of Appeals 10th Circuit, filed by General Counsel.

May 3—Notice of filing petition for review sent to James H. Yeatman filed.

May 6—Motion of 4-29-43 denied.

May 11—Proof of service of petition for review on J. P. Wenchell filed by taxpayer.

May 18—Proof of service of filing petition for review (James H. Yeatman) filed by General Counsel.

May 19—Proof of service of filing petition for review (Dr. W. G. Choate) filed by General Counsel.

May 22—Motion for extension 7-31-43 to transmit record filed by General Counsel.

May 22—Order enlarging time to July 31, 1943 to prepare and deliver the record entered.

Jun. 7—Motion for extension to 7-31-43 to transmit record filed by taxpayer.

Jun. 7—Order enlarging time July 30, 1943 to prepare and deliver the record entered.

[fol. 78] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 79] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

ORDER OF SUBMISSION

First Day, January Term, Monday, January 17th, A D. 1944. Before Honorable Orie L. Phillips and Honorable Sam G. Bratton, Circuit Judges, and Honorable T. Blake Kennedy, District Judge.

These causes came on to be heard and were argued by counsel, James H. Yeatman, Esquire, appearing for W. G. Choate, Helen Goodner appearing for Commissioner of Internal Revenue.

Thereupon these causes were submitted to the court.

In United States Circuit Court of Appeals

Opinion—March 13, 1944

James H. Yeatman for Petitioner and Cross-Respondent Choate.

Helen Goodner (Samual O. Clark, Jr., Assistant Attorney General, and Sewall Key and A. F. Prescott, Special Assistants to the Attorney General, were with her on the brief) for Respondent and Cross-Petitioner Commissioner of Internal Revenue.

Before Phillips and Bratton, Circuit Judges, and Kennedy, District Judge.

Kennedy, District Judge, delivered the opinion of the Court:

This is a tax case in which the taxpayer and the Commissioner of Internal Revenue have petitioned for review of an order of the Tax Court of the United States entered on February 12, 1943.

Briefly stated the litigation arises out of the following circumstances: One Baker executed an oil and gas lease on land owned by her in fee to one Tunstill, which lease provided for a cash consideration with an over-riding royalty. Subsequently, and by mien conveyances, the lease came into the ownership of a co-partnership known as Choate and [fol. 80] Hogan. In 1938, under a contract with the McAlester Fuel Company, a sale was arranged for, which was subsequently carried out by mutual agreement of the parties through an assignment to the Sylvia Oil Company. These instruments provided that Choate and Hogan should convey all their right, title and interest, amounting to 11/16ths of the lease, together with all wells and equipment including pumps, casing, pipe, tanks, leasehouse and other personal property on or used in connection with the premises, including oil in storage, for a consideration of $110,000.00, save and except that Choate and Hogan reserved to themselves 1/8th of 8/8ths of all oil and gas and casinghead gas which should be produced and saved by the purchasing company above a certain depth specifying particularly that said reserve over-riding royalty should be 1/16th of 8/8ths in favor of Choate and 1/16th of 8/8ths in favor of Hogan. The interest of Choate is the only one at issue in this case

and arises under a deficiency assessment for taxation by the Commissioner of Internal Revenue after Choate had made his return for tax purposes in 1938. In making such return the taxpayer computed the tax upon the basis of a sale by allocating the sale price of $110,000.00 as $98,454.70 to the leasehold and $11,545.30 to equipment. The amount allocated to the leasehold was considered on the basis of a long-term capital gain and the amount allocated to equipment was accounted for through depreciation and the tax computed on the remaining difference. The Commissioner computed the tax upon the entire amount of cash consideration upon a depletion basis. Upon appeal the Tax Court sustained the Commissioner as to the computation by the depletion method upon the amount allocated to the leasehold but allowed the taxpayer a computation of the amount allocated to equipment by depreciation. Upon the first part of the decision of the Tax Court the taxpayer seeks review and the Commissioner upon the second.

We are of the opinion that the original conclusions of the Commissioner were correct. Burnet v. Harmel, 287 U. S. 103; Palmer v. Bender, 287 U. S. 551; McLean v. Commissioner, 5th Cir., 120 Fed. 2d, 942; Commissioner v. O'Shaughnessy, 10th Cir., 124 Fed. 2d, 33. These cases hold that the interests of the taxpayer in this situation for [fol. 81] taxation purposes are determined by depletion. In the Palmer case it is said:

> "* * * Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil, in place, which is depleted by production. * * * When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor."

While there may be criticism of the manner in which purported contracts of purchase and sale of leaseholds are characterized by use of the term "sublease", yet it remains clear in principle that where the seller or the lessor retains an interest in the oil in place, his rights therein are

of the same character as those of the purchaser or lessee and subject to depletion.

As to the second point covered by the cross-petition for review by the Commissioner, as intimated, we hold that the computation as to equipment covered by the transaction was likewise subject to the depletion method instead of by the allowance of depreciation as determined by the Tax Court. Cullen v. Commissioner, 5th Cir., 118 Fed. 2d., 651. In cases where the leasehold is not specifically sold separate and distinct from the equipment thereon and the consideration for each specifically segregated the transaction must be considered in its entirety and the cost made recoverable through depletion. In the case at bar no such distinction and separation was made as the cash to be paid covered the leasehold and the equipment as a unit. In a case in our own Court, in Commissioner v. Lewis, 10th Cir., 132 Fed. 2d, 709, it was held upon the facts there presented that the oil reserves and the equipment were sold separately and such had been the finding of the Commissioner. In discussing that phase of the case the opinion says:

> "Ordinarily, a producing oil property consists of the oil reserves and the equipment; and where such [fol. 82] a leasehold estate is sold and conveyed as a unit for an agreed consideration, part in cash and part in oil payment, the cost of the leasehold including the equipment should be allocated between the part sold and the part reserved in proportion to their respective values. But in making the sale of such a leasehold estate, contracting parties are not forbidden by law or public policy to treat the oil reserves and the equipment separately. A vendor may convey an interest in the former, reserve an interest to be paid out of production, and convey the latter with no reservation. That was done here. By the plain terms of the contract, the vendors sold an interest in the oil reserves, reserved an interest to be paid out of production, and sold the equipment outright. They did not retain title, lien, or any kindred economic interest in the equipment. They reserved in it only an option to purchase at its salvage value in the event the vendee should elect to discontinue operations before full payment of the deferred amount out of production. Other than such option, they did not reserve or retain any right what-

ever in the equipment. The contract is clear and not open to any other construction. Therefore in computing the net gain derived by the vendors from the sale, the remaining undepreciated basis of the equipment was deductible in whole from the cash payment. No part of it was allocable to the retained interest."

In the case at bar the instruments clearly on their face reflect that the transaction was one in entirety covering both the oil reserves and the equipment and that consequently the depletion method must be applied to the entire consideration. If the rule were otherwise, it would permit the taxpayer to postpone his determination in segregation of items covered by the cash consideration until he might ascertain the course most advantageous to his pecuniary gain.

The order of the Tax Court is affirmed in No. 2789 and reversed in No. 2790. The proceeding will be remanded to the Tax Court for further action in conformity with the views herein expressed.

[fol. 83] PHILLIPS, Circuit Judge, dissenting in part:

It is my opinion that there was a sale of the equipment and that W. G. Choate and his co-owners retained no interest therein. If this be true, then W. G. Choate was entitled to deduct the depreciated cost of the equipment if it was sold for an amount in excess thereof, or one hundred per cent of the loss if it was sold for an amount less than the depreciated cost. While it is not expressly stated, I conclude from paragraphs 7 and 9 of the agreed statement of facts that the equipment was held for less than eighteen months. Accordingly, it becomes unnecessary to allocate the sale price as between lease and equipment. The mathematical result is the same, whether you deduct the depreciated cost of the equipment from the entire sale price or allocate a portion of the sale price to equipment, deduct the depreciated cost, and determine the gain or loss accordingly. I am unable to see how, under the provisions for depletion of oil and gas wells, a taxpayer can ever recover either his depreciated cost or his capital loss resulting from the sale of equipment. Oil and gas depletion is based not on cost but on a per centum of gross income. See 26 U. S. C. A. §§ 23(m) and 114(b)(3). It would in no wise be in-

creased by reason of depreciation of the equipment. Accordingly, I am of the opinion that the decision of the Tax Court should be affirmed in its entirety. This view is supported by Hogan vs. Commissioner, 5th Cir. (decided February 25, 1944) — F. (2) —.

In United States Circuit Court of Appeals

Judgment

Twenty-seventh Day, January Term, Monday, March 13th, A. D. 1944. Before Honorable Orie L. Phillips and Honorable Sam G. Bratton, Circuit Judges, and Honorable T. Blake Kennedy, District Judges.

These causes came on to be heard on the transcript of the record from The Tax Court of the United States and were argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said The Tax Court of the United States, insofar as it relates to cause [fol. 84] No. 2789, be and the same is hereby affirmed; and that the decision of the said The Tax Court of the United States, insofar as it relates to case No. 2790, be and the same is hereby reversed, and the cause be and the same is hereby remanded to the said The Tax Court of the United States for further proceedings in accordance with the views expressed in the opinion of the court.

[fol. 85] In United States Circuit Court of Appeals
January Term, 1944

Nos. 2789-2790

[Title omitted]

Motion for Rehearing—Filed April 3, 1944

To the Honorable Judges of the United States Circuit Court of Appeals for the Tenth Circuit:

Now comes W. G. Choate by his attorney, James H. Yeatman, and files this his motion for rehearing in the above entitled causes. The grounds for this motion are as follows:

[fol. 86] (1) The primary function and duty of a court is to decide the issues presented to it, if it has jurisdiction to

do so. In these proceedings, this Honorable Court has utterly failed in such duty. One of the questions presented was whether the petitioner had made a sale of an interest in an oil and gas lease such as would entitle him to report the profit as capital gain under Section 117 of the Internal Revenue Code. Nowhere in the decision does it appear that this Honorable Court has undertaken to answer said question. This Honorable Court has decided this particular issue against the petitioner by determining how the cost of the property sold is to be recovered and by considering whether petitioner is entitled to depletion on the net cash received from the sale. Neither the question of cost return nor depletion was the issue in this Honorable Court, or in the court below. In computing the tax deficiency shown by the deficiency notice, the Commissioner allowed depletion on the net cash received by petitioner and below no issue was raised on this point or on the question of the method of cost recovery. The sole and only question presented to this Honorable Court and to the court below was whether or not petitioner had made a sale of a part of his interest in the Baker oil and gas lease. This question remains unanswered by this Honorable Court. In the interest of fairness and justice to this petitioner and hundreds of other taxpayers similarly situated, we respectfully request and urge that this Honorable Court grant a rehearing and determine whether the transaction which the Choate and Hogan partnership had with Sylva Oil Company amounted to a sale of an interest in the Baker lease, and if it finds that the transaction was a sale that it reverse The Tax Court's decision on this point.

For the information of the Court in passing on this motion for rehearing, we wish to point out the following with respect to the statement made in the opinion that where the [fol. 87] seller or the lessor retains an interest in the oil in place his rights are of the same character as those of the purchaser or lessee and subject to depletion. This statement is only partially correct. It is correct as to that part of the minerals *retained* by the vendor, but it is not correct as to that part of the minerals which are *disposed* of by the vendor. The depletion allowance is a creature of statute and under the statutes now in force it would seem that the allowance can be made only as to income derived from production of the minerals and that it is not allowable against income from the sale of the minerals in place. There are

only two subsections of the Code which deal with this subject, the first of which is Section 23 (m) which provides that "in computing net income there shall be allowed as deductions * * * in the case of mines, oil and gas wells, other natural deposits and timber a reasonable allowance for depletion * * *. In any case in which it is ascertained as a result of operations or development work that recoverable units are greater or less than prior estimates thereof then such prior estimate shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate."

The second subsection dealing with the subject is Section 114(b) (3), which in part reads "in the case of oil or gas wells the allowance for depletion under Section 23 (m) shall be 27½ percentum of the *gross income from the property* during the taxable year, et cetera."

This court in Commissioner v. O'Shaugnessy, 124 Fed. (2d) 33, quoted the following from the opinion of Helvering v. Bankline Oil Company, 303 U. S. 362, that "In order to determine whether respondent is entitled to depletion with respect to the production in question we must recur to the fundamental purpose of the statutory allowance. The deduction is permitted as an act of grace. *It is permitted in recognition of the fact that the mineral deposits are wasting* [fol. 88] *assets and it is intended as compensation to the owner for the part used up in production.*"

We think it plain from the foregoing quoted matter, from Section 23 (m) and Section 114 (b) (3), and from what the Supreme Court said in the Bankline case that the allowance for depletion is applicable only to income derived from production of minerals and is not applicable to income derived from the sale of the minerals or part of the minerals in place. It is not believed that said statutes, or the Supreme Court's decision in the Bankline case can be interpreted otherwise. The income in controversy in this case was not derived by petitioner from production of the oil and gas underlying the Baker lease. It was derived by petitioner from the sale of a part of his interest in the oil and gas in place which went over to the Sylva Oil Company. This statement is not subject to refutation. Although, as stated above, the question of how petitioner's cost is to be returned to him is not the issue in this case, we submit that under the statutes, this Court has erred in its conclusion that the cost

of petitioner's interest in the Baker lease is recoverable through depletion.

The second question presented in these proceedings is whether or not petitioner is entitled to deduct the undepreciated cost of the equipment which was on the Baker lease at the time the transaction with the Sylva Oil Company was had. This Court in reversing The Tax Court holds that the cost of the equipment is recoverable through the depletion method instead of "by allowance for depreciation" as determined by The Tax Court and cites Cullen v. Commissioner (5th C. C. A.), 118 Fed. (2d) 651, and Commissioner v. Lewis (10th C. C. A.), 132 Fed. (2d) 709. The holding in the Cullen case that the cost of the equipment on the leases with respect to which overriding royalties were retained is recoverable through percentage depletion was reversed by [fol. 89] the Fifth Circuit Court of Appeals in the companion to this case, Commissioner of Internal Revenue v. Fred T. Hogan (5th C. C. A.), decided Feb. 25, 1944, — Fed. (2d) —. With respect to this point, the Fifth Circuit Court of Appeals said:

> "We also agree with The Tax Court that title to the equipment passed from the partnership to Sylva Oil Company under the assignment, and that the partnership was entitled to deduct from the cash consideration the depreciated cost of said equipment. The assignment conveyed to Sylva Oil Company not only an interest in a producing oil and gas lease, but all equipment thereon. Under the Act, depletion percentage on the bonus received and the royalty reserved is not a deduction associated with equipment cost. Equipment cost is recoverable through depreciation allowances and not 'by percentage depletion allowances,' as apparently was inadvertently stated in Cullen v. Commissioner. It is only with respect to wasting assets that depletion allowances are made."

With respect to the conclusion reached in the majority opinion that the decision in the Lewis case is not controlling because there the equipment was sold separately and here the leasehold and equipment were sold as a unit, we respectfully urge upon this Court that the equipment involved in the present case was sold just as separately as was the equipment involved in the Lewis case. This is clear from

an examination of the language of instruments of conveyance involved in said cases, from which we quote:

[fol. 90]

Lewis Case

"In 1935 the partnership purchased two nonproducing oil and gas leases for a total consideration of $120. Upon these leases the partnership placed certain equipment for the production of oil. On March 23, 1937, the partnership sold the two leases for a cash consideration of $150,000 and an oil payment of $125,000 payable out of one-fourth of seven-eighths of any oil produced from the leases. The contract provided in part as follows:

"'4. It Is Further Understood and Agreed that for the consideration above named, said Second Party (vendee) shall be entitled to all of the material now in the ground on said aforedescribed premises, as well as the derricks over the wells now producing, or in the course of drilling on said aforedescribed premises, together with the lead-lines, well-head connections, tank battery, separators, and water wells now situated on said aforedescribed premises.' (Findings of Fact by Tax Court, Memo Op. entered Jan. 22, 1942.)

Choate Case

"Now, therefore, for and in consideration of One Dollar ($1.00) and other good and valuable considerations, the receipt of which is hereby acknowledged, the undersigned L. H. Choate and Fred T. Hogan, * * * do hereby bargain, sell, assign and convey, subject to all of the terms and conditions, and the reservation of 1/16th overriding royalty in said assignment from Continental Oil Company to Roy R. Brown, all right, title and interest of the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, in so far as the same covers and affects the oil, gas and casinghead gas, and the oil, gas and casinghead gas right, at and above the depth of two thousand seven hundred fifty feet from the surface in and under the said 230 acres of land above described, together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, * * *." (R. p. 20.)

[fol. 91] It is true that in the present case the consideration paid by the vendee was in a lump sum amount for both the leasehold and the equipment thereon. But the same thing was true in the Lewis case. The above quotation from the conveyance in the Lewis case shows that no division of the consideration was made as between leasehold and equipment. Then how can it be said that in the Lewis case the equipment was sold separately and here that the leasehold and equipment were sold as a unit? If the words "It is further understood and agreed that for the consideration above named" appearing in the Lewis assignment are substituted for the words "together" in the Choate assignment, the assignments would be in all substantial respects the same. We submit that the difference between the two assignments is in verbiage only and that in substance no valid distinction exists between the two cases.

Choate and Hogan were partners. The assignment in the present case is the same assignment as was involved in the case of Commissioner v. Hogan, supra. As previously stated, the Fifth Circuit Court held that the cost of the equipment was deductible from the cash consideration paid the partnership for the lease as determined by The Tax Court, and reversed its decision in the Cullen case which the majority cited in support of the conclusion that the cost of the equipment is recoverable through the "depletion method." Thus we have the tax liability of members of the same partnership arising out of the same transaction computed upon different bases and with different tax results to each partner.

We submit on this point that a rehearing should be granted and the decision of The Tax Court should be affirmed for the following reasons:

1. The decision of the Fifth Circuit Court in Culler v. Commissioner, supra, which this Court cited and evidently [fol. 92] relied on in reaching the conclusion that the cost of the equipment is recoverable through depletion, was reversed in Commissioner v. Hogan, supra, and the Cullen decision is therefore no longer any authority for such proposition.

2. There is no substantial difference between the present case and Commissioner v. Lewis, supra, and the Lewis decision establishes the law of this case. In this case just as

in the Lewis case title to all of the equipment on the lease passed to the vendee.

3. The cost of depreciable property cannot be legally recovered through depletion allowances. It can be recovered only through annual depreciation allowances or as an offset against the consideration received for the property. (See Statutes cited page 34 of petitioner's original brief and Judge Phillips' dissenting opinion.)

Wherefore, it is prayed that a rehearing be granted and that upon same being had this Honorable Court reverse the decision of The Tax Court in No. 2789 and affirm the decision of The Tax Court in 2790.

James H. Yeatman, Counsel for W. G. Choate.

[fol. 93] James H. Yeatman, counsel for petitioner, W. G. Choate, certifies that he prepared the within Motion for Rehearing; that said motion is believed to be meritorious; that it is not vexatious; and is not interposed for the purpose of delay.

James H. Yeatman, Counsel for W. G. Choate.

Of Counsel: Vinson, Elkins, Weems & Francis, 11th Floor Esperson Building, Houston 2, Texas.

[File endorsement omitted.]

[fols. 94-95] In United States Circuit Court of Appeals

Order Denying Petition for Rehearing

Forty-second Day, January Term, Saturday, April 8th, A. D. 1944. Before Honorable Orie L. Phillips and Honorable Sam G. Bratton, Circuit Judges, and Honorable T. Blake Kennedy, District Judges.

These causes came on to be heard on the petition of W. G. Choate for a rehearing herein.

On consideration whereof, it is now here ordered that the said petition be and the same is hereby denied.

On April 19, 1944, the mandate of the United States Circuit Court of Appeals, in accordance with the opinion and judgment of said court, was issued to The Tax Court of the United States.

Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 96] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 9, 1944

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Tenth Circuit is granted, limited to the second question presented by the petition for the writ and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[fol. 97] IN THE SUPREME COURT OF THE UNITED STATES

STIPULATION AS TO PRINTING OF RECORD—Filed October 26, 1944

It is stipulated and agreed by and between the parties, by and through their respective attorneys of record, that the following parts of the record may be omitted from the record to be printed for this court, said omitted matter not being essential to the consideration of the question as to which the petition for certiorari was granted by this court.

1. Page 9 of the record, all of Exhibit "B";
2. Page 15 of the record, all of Exhibit "C";

• • • • • • •

4. Page 48 of the record, all of petitioner's Exhibit 1;
5. Page 59 of the record, all of petitioner's Exhibit 2;
6. Page 61 of the record, all of petitioner's Exhibit 3;
7. Page 63 of the record, all of petitioner's Exhibit 4;
8. Page 66 of the record, all of petitioner's Exhibit 5;
9. Page 68 of the record, all of petitioner's Exhibit 6;

• • • • • • •

[fol. 98] 11. Pages 73-74 of the record, all of petitioner's Exhibit 9;

12. Pages 74-75 of the record, all of petitioner's Exhibit 10;

13. Page 75 of the record, all of petitioner's Exhibit 11.

James H. Yeatman, Counsel for Petitioner; Charles Fahy, Solicitor General, Counsel for Respondent.

[fol. 99] [File endorsement omitted.]

Endorsed on Cover: Enter Charles I. Francis. File No. 48,519. U. S. Circuit Court of Appeals, Tenth Circuit. Term No. 93. W. G. Choate, Petitioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed May 23, 1944. Term No. 93 O. T. 1944.

FILE COPY

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MAY 23 1944
CHARLES ELMORE CROPLEY
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. 1026[illegible] 93

W. G. CHOATE, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

COMMISSIONER OF INTERNAL REVENUE, *Cross-Petitioner*,

v.

W. G. CHOATE, *Cross-Respondent*

PETITION FOR WRITS OF CERTIORARI

to the United States Circuit Court of Appeals
For the Tenth Circuit

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INDEX

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
Statutes Involved	3
Statement	3
Specification of Errors to Be Urged	6
Reasons Relied on For the Allowance of the Writ	6
Appendix	14

CITATIONS

PAGE

CASES

Bonwit Teller & Co. v. U. S., 283 U.S. 258 12
Bowers v. New York & Albany Lighterage Co., 213 U.S. 346 12
Burnett v. Harmel, 287 U.S. 103 12
Burnett v. Niagara Falls Brewing Co., 282 U.S. 648 12
Butler v. Thomson, 92 U.S. 412 10
Columbia Oil & Gas Co. v. Commissioner, 118 Fed. (2d) 459 7
Commissioner v. A. & P. Production Co., 122 Fed. (2d) 459 7
Commissioner v. American Liberty Oil Co., 127 Fed. (2d) 262 7
Commissioner v. Lewis, 132 Fed. (2d) 709 7, 9
Commissioner v. McAlbert Oil Co., Inc., 122 Fed. (2d) 192
Commissioner v. Roeser & Pendleton, Inc., 118 Fed. (2d) 462 9
Cullen v. Commissioner, 118 Fed. (2d) 651 9
Fleming v. Commissioner, 82 Fed. (2d) 324 9
Griffiths v. Helvering, 308 U.S. 355 10
Helvering v. Tex-Penn Oil Co., 300 U.S. 481 10
Hogan v. Commissioner, 141 Fed. (2d) 92 5
Lee v. Commissioner, 126 Fed. (2d) 825 9
McLean v. Commissioner, 120 Fed. (2d) 942 9
Roeser & Pendleton, Inc., v. Commissioner, 118 Fed. (2d) 462 9
Sheppard, et al., v. Stanolind Oil & Gas Co., 125 S.W. (2d) 643 9
Smith v. Higgins, 308 U.S. 651 10
State, et al., v. Quintana Petroleum Corp. (Sup. Ct. of Tex.); 134 Tex. 179, 133 S.W. (2d) 112 9
Thomas v. Perkins, 301 U.S. 655 11
U. S. v. Merriam, 263 U.S. 179 12
U. S. v. Phellis, 257 U.S. 156 10
U. S. v. Updyke, 281 U.S. 489 12
West Production Co. v. Commissioner, 121 Fed. (2d) 9 9

STATUTES

	PAGE
Revenue Act of 1938:	
Sec. 22(a)	14
Sec. 23(1) and (m)	14
Sec. 111	15
Sec. 114(b) (3)	15
Sec. 117(a) (1)	16
(a) (4)	16
(b)	16

MISCELLANEOUS

Excerpt From House Report No. 350 Ways and Means Committee on the Revenue Act of 1921	16

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No.

W. G. CHOATE, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

COMMISSIONER OF INTERNAL REVENUE, *Cross-Petitioner*,

v.

W. G. CHOATE, *Cross-Respondent*

PETITION FOR WRITS OF CERTIORARI

to the United States Circuit Court of Appeals For the Tenth Circuit

TO THE HONORABLE THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The petitioner, W. G. Choate, prays that a writ of certiorari issue to review the decision and judgment of the United States Circuit Court of Appeals for the Tenth Circuit entered March 13, 1944, in the case of W. G. Choate, Petitioner, v. Commissioner of Internal Revenue, Respondent, and Commissioner of Internal Revenue, Cross-Petitioner, v. W. G. Choate, Cross-Respondent, Nos. 2789 and 2790 (R. pp. 79-84).

Opinions Below

The Memorandum Opinion of The Tax Court of the United States (R. 24-34) is unreported. The Opinion of the Circuit Court of Appeals is reported at — Fed. (2d) — (C.C.A. 10th, March 13, 1944), and appears on pages 79 to 84 of the record.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240(a) of the JUDICIAL CODE as amended by the Act of February 13, 1925. The judgment of the Circuit Court of Appeals was entered March 13, 1944. A petition for rehearing was filed within twenty (20) days after entry of the judgment and was denied April 8, 1944 (R. p. 94).

Questions Presented

1. Where an interest in an oil and gas lease is assigned for a cash consideration with the assignor retaining and not selling 1/8th of 8/8ths of all oil and gas produced and saved from the premises, is the transfer a sale and the profit taxable as long-term capital gain under Section 117 of the REVENUE ACT OF 1938 (App. p. 16), or is it a sublease and the profit taxable as ordinary income under Section 22(a) of the Act? (App. p. 14.)

2. Where title to the equipment on the lease passes to the assignee absolutely without any interest therein being reserved to the assignor, is the unrecovered cost of the equipment deductible from the cash consideration in computing the gain, or must it be recovered through depletion allowance applicable to the production from the retained interest in the oil reserves?

Statute and Regulations Involved

The Statute and Regulations involved will be found in the Appendix, infra, pp. 14 to 17.

Statement

This is a companion case with Hogan v. Commissioner and Commissioner v. Hogan, 141 Fed. (2d) 92 (C.C.A. 5th, Feb. 25, 1944), which is in direct conflict with this case on one point.

On December 18, 1936, Fred T. Hogan and L. H. Choate, acting for themselves and W. G. Choate, the petitioner herein, acquired an oil and gas lease by assignment from one Roy R. Brown. The lease had been originally executed by Mrs. M. L. Baker, the fee owner, and covered a tract of land situated in Upton County, Texas. After the lease was acquired from Brown, a partnership was formed under the name of Choate & Hogan to own, develop and operate the property for the production of oil and gas. Petitioner owned a one-fourth interest in said partnership. Subsequently, the partnership developed the Baker lease by drilling six producing oil wells thereon. Said wells were completed prior to October 11, 1938. On the latter date, Choate and Hogan, acting for the partnership, entered into a written contract (R. 69) to sell an interest in the lease to McAlester Fuel Company for a cash consideration of $110,000.00 to be paid by the buyer; and the contract further provided that the sellers were to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8th of 8/8ths of all oil and gas produced and saved from the lease by the buyer. On August 22, 1938, Choate & Hogan executed an assignment (R. 18) of the lease, together with all the equipment thereon, to the Sylva Oil Company (nominee of McAlester Fuel Company, R. 73), and in said assignment it was provided, among other

things, that "assignors herein expressly reserve to themselves, their heirs and assigns, and *do not assign or convey* to the assignee herein, 1/8th of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by the Sylva Oil Company."

In the partnership return filed by Choate & Hogan for the year 1938, the profit from the sale of the interest in the lease was reported as long-term capital gain pursuant to Section 117 of the REVENUE ACT OF 1938. The respondent determined that the transaction with the Sylva Oil Company was a sublease rather than the sale of a capital asset and that the profit could not be treated as a long-term capital gain. He treated the cash consideration of $110,000.00 as a lease bonus, allowed depletion thereon at the rate of 27½% (Section 114(b) (3), App. p. 15) of the REVENUE ACT OF 1938), and taxed the remainder as ordinary income. (Section 22 (a) of the Act. App. p. 14.)

In his computation, respondent made no allowance for the undepreciated cost of the equipment ($23,090.60) which was on the lease at the time of the sale, and held that such undepreciated cost was recoverable through depletion allowances applicable to production from the retained interest of 1/8th of 8/8ths.

The Tax Court held (1) that the petitioner was not entitled to treat the transfer of the interest in the lease as a sale, but must look to depletion for the return of his capital; and (2) that the unrecovered cost of the equipment on the lease at the time of the transfer is to be deducted in full from the cash consideration in determining the amount of the gain subject to the depletion allowance (R. 24-34).

Both the petitioner and the Commissioner appealed and the Tenth Circuit Court of Appeals sustained The Tax Court's decision on the first point and reversed its decision on the second point. The Fifth Circuit Court of Appeals in the com-

panion cases of Fred T. Hogan v. Commissioner and Commissioner v. Fred T. Hogan, 141 Fed. (2d) 92, affirmed the decision of The Tax Court on both points.

Specifications of Error to Be Urged

1. The court below erred in holding that petitioner did not make a sale of an interest in the Baker lease and that for taxation purposes his interest is determined by depletion.

2. The court below erred in holding that the undepreciated cost of the equipment is not deductible from the cash consideration of $110,000.00 but is to be returned through depletion allowances applicable to production from the retained interest.

Reasons Relied Upon for the Allowance of the Writ

FIRST. There is a direct conflict between the decision of the Tenth Circuit in this case and the Fifth Circuit in the companion case of COMMISSIONER V. HOGAN, supra, on the second point. The Fifth Circuit Court held that in computing the net gain realized on the transfer, the unrecovered cost of the lease equipment is deductible from the cash consideration of $110,000.00 received for the property. The Tenth Circuit Court held that the unrecovered cost of the lease equipment is not so deductible and that same must be recovered through depletion allowances. There is, therefore, a clear conflict in the decisions of the two Circuit Courts of Appeal on the tax liability of members of the same partnership and arising out of the same transaction.

The decision of the Tenth Circuit Court of Appeals on the equipment issue is clearly erroneous and should be reversed. Petitioner disposed of all his right, title and interest in the lease equipment and retained no interest whatever therein. The leasehold equipment is depreciable property. The cost of depreciable property is recoverable only in one

or two ways; first, through annual allowances for depreciation (Sec. 23 (m), Appendix p. 14), and secondly as an offset against the selling price if the property is sold or exchanged (Sec. 111 (a), Appendix p. 15). The cost of depreciable property cannot lawfully be recovered by way of depletion allowances either under Sec. 23(1) or (m), or Sec. 114(b) (3), Appendix p. 15). The purpose of these provisions is to compensate the owner of the oil, gas or other minerals for the quantity which is exhausted or dissipated by production. Said provisions have no reasonable relation to the exhaustion, wear and tear of the machinery used to produce the minerals and the cost of the machinery is not recoverable thereunder, and unless petitioner is permitted to deduct the cost of his equipment from the cash consideration received from the sale said cost will never be returned to him.

The Fifth and Tenth Circuit Courts of Appeal have uniformly held that the full cost of the equipment is deductible when the sale is for cash and an oil payment is retained by the vendor. COMMISSIONER v. A. & P. PRODUCTION CO., 122 Fed. (2d) 192; COMMISSIONER v. MCALBERT OIL CO., INC., 122 Fed. (2d) 192; COMMISSIONER v. AMERICAN LIBERTY OIL CO., 127 Fed. (2d) 262; COMMISSIONER v. ROESER & PENDLETON, INC., 118 Fed. (2d) 462; COLUMBIA OIL & GAS CO. v. COMMISSIONER, 118 Fed. (2d) 459 (all by C.C.A. 5th), and COMMISSIONER v. LEWIS, 132 Fed. (2d) 709, (C.C.A. 10th). As hereinafter shown, there is no difference in quality or character between an oil payment and an overriding royalty.

The Tenth and Fifth Circuit Courts of Appeal each held that the taxpayer is not entitled to treat the transfer of the interest in the lease itself as a sale and the resulting profit as long-term capital gain. On this point, both courts held that the taxpayer's rights are determinable by depletion. The in-

terest in the lease and the equipment were disposed of as a unit in a single transaction. By the terms of the sales contract, the partnership agreed to sell an interest in the lease, together with all equipment on the lease and title to the interest in the lease and the equipment was conveyed by a single instrument of conveyance. Should this Court undertake to review the decision of the Tenth Circuit Court on the equipment issue, as to which the conflict exists, it will be necessary for it to examine both the contract of sale and the assignment, and no additional burden will be imposed on the Court if it also undertakes to review said decision on the issue as to whether the transaction was a sale or a sublease. Furthermore, as hereinafter pointed out, this question is of first importance to the oil industry as a whole. For these reasons we respectfully urge the Court to grant this petition and review the decision of the Tenth Circuit Court of Appeals in its entirety.

SECOND. Approximately sixty-five percent of the known oil reserves of the United States are located in the States of Texas, Louisiana and Mississippi, which States are included within the Fifth Judicial Circuit of the United States. There are also substantial oil reserves in certain of the States embraced within the Tenth Circuit, such as Oklahoma, New Mexico and Colorado. Assignments of oil and gas leases are made in said States practically every day in the year. A customary practice in the industry is for the assignee to pay the assignor a cash consideration, with the assignor retaining an overriding royalty or an oil payment in a certain amount payable out of a fraction of the production. An important question of federal law which has not been, but should be settled by this Court, arises in the case of each of such assignments, namely, for federal tax purposes, are transactions of such character sales of capital assets, and do they give rise to capital gains or losses which are limited by Section 117 of

the REVENUE ACT of 1938, or are they so-called subleases, the gain and loss on which is recognizable in full for federal tax purposes? The Fifth Circuit Court has arbitrarily held that the transaction is a sale if an oil payment is retained by the vendor, but that it is a sublease where the retained interest is stated in terms of an overriding royalty. CULLEN v. COMMISSIONER, 118 Fed. (2d) 651; WEST PRODUCTION CO. v. COMMISSIONER, 121 Fed. (2d) 9; MCLEAN v. COMMISSIONER, 120 Fed. (2d) 942; FLEMING v. COMMISSIONER, 82 Fed. (2d) 324; ROESER & PENDLETON, INC. v. COMMISSIONER, 118 Fed. (2d) 462 (all by C.C.A. 5th). The Tenth Circuit Court of Appeals has made the same distinction, Commissioner v. Lewis, 132 Fed. (2d) 709, and CHOATE v. COMMISSIONER, supra (Record 79). These rulings have been made notwithstanding it is the settled law of Texas that an oil payment and an overriding royalty are each real property of like kind and character. STATE, ET AL., v. QUINTANA PETROLEUM CORP., ET AL. (Supreme Ct. of Texas), 134 Tex. 179, 133 S.W. (2d) 112; SHEPPARD, ET AL., v. STANOLIND OIL & GAS CO. (Austin Ct. of Civil Appeals, writ of error refused), 125 S.W. (2d) 643. Thus the distinction made by the Fifth and Tenth Circuit Courts between an oil payment and an overriding royalty is a distinction without a difference. See also LEE v. COMMISSIONER, 126 Fed. (2d) 825, where the Fifth Circuit Court held that oil payments and overriding royalties are to be treated alike for depletion purposes.

The effect of the decisions of the Fifth and Tenth Circuits has been to deprive taxpayers of the special benefits accorded them by the statutes relating to taxation of capital gains, which statutes were intended to be and are remedial in character. Under the said decisions, a taxpayer cannot make a sale of an oil and gas lease and secure taxation of the gain at capital gain rates if he retains an interest in the form of an

overriding royalty, and this is true notwithstanding every essential element of a sale is present in the transaction, namely: (1) Parties competent to contract; (2) mutual assent; (3) a thing, the absolute or general property in which is transferred from the seller to the buyer; and (4) a price in money paid or promised. (BUTLER v. THOMSON, 92 U.S. 412.) Thus, the question is of the utmost importance to the vast number of taxpayers who own oil and gas leases. The question is also important from the standpoint of the Treasury because under the decisions of the Fifth and Tenth Circuits, as they now stand, a taxpayer owning an oil and gas lease can effect a transfer of it in a manner which will permit him to control the amount of gain or loss thereon which will be recognizable for tax purposes. This Court should, therefore, review the decision of the Tenth Circuit Court of Appeals herein in its entirety in order that a rule of law may be established which will be applicable in all cases, whether an overriding royalty or an oil payment is retained by the assignor.

THIRD. This Court has affirmed the doctrine that in tax matters substance always controls over form. U. S. v. PHELLIS, 257 U.S. 156; HELVERING v. TEX-PENN OIL CO., 300 U.S. 481; SMITH v. HIGGINS, 308 U.S. 561; and GRIFFITHS v. HELVERING, 308 U.S. 355. The Circuit Court of Appeals for the Fifth and Tenth Circuits in the cases cited supra applied an arbitrary rule of thumb or yardstick in determining whether the transactions were sales or subleases. If the reservation was in the form of an oil payment, the transaction was held to be a sale; if stated in terms of an overriding royalty, the transfer was held to be a sublease. Thus, the decisions were made to turn entirely and exclusively on the type of reservation that was contained in the instrument of conveyance. Form and form alone has been the dominating and decisive guidepost followed in rendering the said decis-

ions and judgments. The type of reservation has been applied as an all-exclusive test in determining the nature of the transaction. Proof of this fact is ably demonstrated by the incongruous results reached by the Fifth Circuit Court in CULLEN's case where, despite the fact that the twelve leases were conveyed by a single instrument in a single transaction, it was held as to the nine leases in which overriding royalties were retained that the transfers were subleases, and as to the three leases in which oil payments were retained that the transfers were sales. The court below has given no heed whatever to the substance of what was done. Accordingly, its decision and judgment conflict in principle with the settled law established by this Court that in applying our tax laws the courts will not exalt form over substance.

FOURTH. The decision of the court below is also believed to be in conflict in principle with the decision of this Court in THOMAS v. PERKINS, 301 U.S. 655. In such case, an oil and gas lease was conveyed to the taxpayer for a cash consideration plus a sum to be paid out of the oil produced and saved from the lands. The Collector sought to tax the assignee with the amounts paid by him over to the assignor on the oil payment. This Court held that the fraction of the oil required to liquidate the oil payment did not pass to the assignee by virtue of the terms of the assignment and that such fraction of the oil reserves had been retained by and belonged to the assignor, and that the assignee was not taxable on the proceeds therefrom. Although this Court did not pass directly on the question of whether the assignor had made a sale of the fraction of the oil that passed to the assignee, it did recognize that a taxpayer owning an oil and gas lease can make a sale of a fractional interest therein and retain a fractional interest. The court below has refused to treat and recognize as a sale a transfer of a lease if an overriding royalty is retained by the transferor and its decision

is probably in conflict with the decision of this Court in THOMAS v. PERKINS, supra.

FIFTH. Before the Revenue Act of 1921 gains realized from the sale of property were taxed at the same rates as other income with the result that capital gains often accruing over a long period of time were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provision of the 1921 Revenue Act for taxing capital gains at a lower rate, reënacted in one form or another in all subsequent Revenue Acts, were *"adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments and to remove the deterrent effect of those burdens on such conversions."* BURNETT v. HARMEL, 287 U.S. 103, and HOUSE REPORT NO. 350, WAYS AND MEANS COMMITTEE, 67th Congress, First Session, on the Revenue Bill of 1921 (App. p. 16).

It is clear from this Court's decision in the HARMEL case and the Report of the Committee on Ways and Means that the new provision of the Revenue Act of 1921 taxing capital gains at a lower rate than ordinary income was taxed was intended as a relief measure. This Court has repeatedly held that relief statutes are to be construed liberally in favor of taxpayers in order that they will receive the benefit of the relief the statutes were intended to provide. BONWIT TELLER & Co. v. U. S., 283 U.S. 258; U. S. v. MERRIAM, 263 U.S. 179; BOWERS v. NEW YORK & ALBANY LIGHTERAGE CO., 213 U.S. 346; U. S. v. UPDYKE, 281 U.S. 489; and BURNETT v. NIAGARA FALLS BREWING CO., 282 U.S. 648.

The gain involved in this proceeding resulted from the conversion of a capital asset, namely: an interest in an oil and gas lease on which there were six producing oil wells at the time of the transfer. The lease had been held by the partnership for the requisite length of time for the gain on the

transfer to be taxed as long-term capital gain. All of the gain did not accumulate in the year of realization. It accrued over the period of time the lease was held and owned by the partnership. If the gain is treated as ordinary income, 100% of it will be taxable; whereas, if it is treated as long-term capital gain, only 60% will be includible in income. If the gain is treated as ordinary income, it will fall in a higher surtax bracket than it would if treated as long-term capital gain; consequently, petitioner is within that class of taxpayers which the capital gain provisions were intended to reach and benefit by relieving them from excessive surtax burdens when a capital asset is converted at a profit.

Notwithstanding the above situation, the court below held that the petitioner was not entitled to *treat* the transaction as a sale. In doing so, the court has not construed the statutes liberally in petitioner's favor. On the contrary, the statute has been construed most liberally in favor of the Government. Thus it appears that the court below has violated the principle long since settled by the decisions of this Court that relief statutes are to be given a liberal construction in favor of taxpayers in order to give them the relief the statutes were intended to provide.

It is respectfully submitted that this petition should be granted on both points.

James F. Coatman
Chas. I. Francis
Attorneys for Petitioner

Appendix

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

(l) DEPRECIATION.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income of the beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In

any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.
* * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(b)(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under Section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23(m) be less than it would be if computed without reference to this paragraph.

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) (1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23 (l).

(a) (4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income.

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

HOUSE REPORT NO. 350. WAYS AND MEANS COMMITTEE ON THE REVENUE ACT OF 1921.

"The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of

surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transaction to go forward without fear of a prohibitive tax, the proposed bill, in Section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 93

W. G. CHOATE, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit

BRIEF FOR THE PETITIONER

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SUBJECT INDEX

	PAGE
Opinions Below	1
Jurisdiction	1
Question Presented	2
Statutes and Regulations Involved	2
Statement	2
Summary of the Argument	5
Argument	7
Conclusion	20
Appendix	21

LIST OF AUTHORITIES

	PAGE
Commissioner v. Columbia Oil & Gas Co., 118 Fed. (2d) 459, affirming 41 B.T.A. 38	14
Commissioner v. Hogan, 141 Fed. (2d) 92	5, 15, 26
Commissioner v. Lewis, 132 Fed. (2d) 709	8, 14
Cullen v. Commissioner, 118 Fed. (2d) 651	7, 14, 15
Dakota-Montana Oil Co. v. U. S., 288 U.S. 459, 53 S. Ct. 435	16
Hogan v. Commissioner, 141 Fed. (2d) 92	5, 15, 26
Revenue Act of 1938:	
Section 23(m)	12, 25
Section 111(a)	12, 25
Section 113(a)	10, 22
Section 113(a)(14)	10, 22
Section 114(b)(1)	10, 22
Section 114(b)(3)	7, 10, 21
Regulations 101, Art. 23:	
(m)-1(g)	10, 21
(m)-2	10
(m)-16	10
(m)-18	12, 26
Sheppard v. Stanolind Oil & Gas Co., 125 S.W. (2d) 643	14
State, et al., v. Quintana Petroleum Co. (Tex. Sup.), 133 S.W. (2d) 112	14
Thomas v. Peckham, 115 Fed. (2d) 685	14

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BRIEF FOR THE PETITIONER

Opinions Below

The Memorandum Opinion of The Tax Court (R. 13), is unreported. The opinion of the Circuit Court of Appeals for the Tenth Circuit (R. 43), is reported at 141 Fed. (2d) 641.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered March 13, 1944 (R. 47). A petition for rehearing was filed April 3, 1944 (R. 47), and denied April 8, 1944 (R. 53). A petition for a writ of certiorari was filed May 23, 1944, and granted October 9, 1944, limited to the second question presented by the petition for the writ (R. 54). The jurisdiction of this Court is conferred by Section 240(a) of the JUDICIAL CODE as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where title to the depreciable equipment on an oil and gas lease passed to the assignee absolutely without any interest therein being reserved to the assignor, is the unrecovered cost of the equipment deductible from the cash consideration in computing the gain, or must it be recovered through depletion allowances applicable to production from the retained interest in the oil reserves?

Statutes and Regulations Involved

The statutes and regulations involved will be found in the Appendix hereof (p. 21).

Statement

The petitioner was a member of a partnership which owned and operated an oil and gas lease on lands situated in the State of Texas, on which there were six producing oil wells. On October 11, 1938, the partnership contracted to sell the lease, together with all of the leasehold equipment to McAlester Fuel Company for a cash consideration of $110,000, with the sellers excepting and reserving to themselves, their heirs and assigns, an overriding royalty of 1 8th of 8/8ths of all oil and gas produced and saved by the buyer (R. 36). On August 22, 1938, the partnership assigned the lease, together with all of the equipment thereon to the Sylva Oil Company (nominee of McAlester Fuel Company), reserving to themselves 1/8th of 8 8ths of all the oil and gas produced, as provided in the contract of October 11. The sellers reserved no interest in the well equipment or other personal property that was on the lease at the time of the sale, and all their right, title and interest therein passed to the buyer

by virtue of the terms of the assignment (R. p. 8). The respondent allowed the Sylva Oil Company to deduct depreciation on the equipment after it was assigned to that company.[1]

In the return filed by the partnership for the year 1938, the profit from the sale of the interest in the lease was reported as long-term capital gain and the loss on the sale of the equipment as a short-term loss (Sec. 117 of the REVENUE ACT of 1938), as follows:

	Leasehold	Equipment	Total
Sale Price . . .	$98,454.70	$11,545.30	$110,000.00
Less Cost of Sale:			
Gross Cost . .	$33,391.80	$30,206.49	$ 63,598.29
Less—Reserves for Depletion and Depreciation . .	9,808.02	7,115.89	16,923.91
Net Cost of Sale .	$23,583.70	$23,090.60	$ 46,674.38
Gross Gain from Sale	$74,870.92	($11,545.30)	$ 63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	($11,545.30)	$ 60,325.62
Taxable Gain from Sale (Sec. 117, Revenue Act of 1938) . . .	$47,913.95	($11,545.30)	$ 36,368.65

The respondent held that the transaction constituted a

[1] It (Sylva Oil Co.) claimed depreciation on the cost thus allocated to equipment in its return for the year 1938 in the amount of $1,671.17, and in its income tax return for 1939 in the amount of $5,613.35 which amounts were allowed to it for those years as depreciation on the equipment by the Commissioner of Internal Revenue after an examination by his agent (Findings of Fact Tax Court, R. 18).

sublease rather than a sale of a capital asset, and he computed the profit as follows:

"Oil Income" . . .		$110,000.00
Less—Depletion . . .	$30,250.00	
Less—Commission . .	3,000.00	33,250.00
Net Income		$ 76,750.00

Respondent, however, made no allowance for the undepreciated cost of the equipment that was on the lease at the time of sale, and held that such cost was recoverable through depletion allowances applicable to production from the retained interest of 1/8th of 8/8ths (R. 20).

In the proceeding in The Tax Court, the petitioner contended that the transaction constituted a sale of a capital asset, but plead in the alternative that if The Tax Court determined that the transaction was not a sale in so far as the leasehold itself was concerned, that the partnership parted with all of its right, title and interest in the equipment and was entitled to have the undepreciated cost of the equipment ($23,090.60), deducted from the cash consideration of $110,000 in determining the gain.

The Tax Court held, (1) that the partnership was not entitled to treat the transfer of the interest in the lease as a sale, but must look to depletion for the return of its capital; and (2) that the unrecovered cost of the equipment on the lease at the time of the transfer is deductible in full from the cash consideration in determining the amount of gain subject to the depletion allowance (R. 13). Both the petitioner and the Commissioner appealed to the Tenth Circuit Court of Appeals and that court sustained the holding of The Tax Court that the transfer of the interest in the lease could not be treated as a sale due to the fact that an overriding royalty was retained by the sellers, but reversed The

Tax Court on the issue relating to the equipment. Said court held that the cost of the equipment must be recovered through percentage depletion applicable to the proceeds from the retained royalty. In the companion case of FRED T. HOGAN v. COMMISSIONER and COMMISSIONER v. FRED T. HOGAN, 141 Fed. (2d) 92 (Hogan was one of the partners), the Fifth Circuit Court of Appeals affirmed the decision of The Tax Court on both points (App. p. 26).

Petitions for writs of certiorari were duly filed in this Court by the petitioner and Fred T. Hogan and this Court was asked to pass on both of the questions involved in The Tax Court proceedings. This Court granted the writ in the instant case, but limited it to the question of whether or not the undepreciated cost of the equipment on the lease at the time of sale is to be deducted from the cash consideration in determining the gain, or whether such cost is to be recovered through depletion allowances applicable to the retained interest.

Summary of the Argument

1. The Tenth Circuit rested its decision on the decision of the Fifth Circuit in CULLEN v. COMMISSIONER, infra. The Fifth Circuit repudiated and reversed its decision in the CULLEN case in HOGAN v. COMMISSIONER, supra. Accordingly the CULLEN decision is no authority for the holding of the Tenth Circuit.

2. The lease and the equipment in the instant case were no more sold as a unit than was the lease and equipment in the case of LEWIS v. COMMISSIONER, infra. Hence, there is no valid distinction between the two cases and the Tenth Circuit should have followed its LEWIS case decision herein.

3. The cost of the equipment cannot be returned to pe-

titioner through either percentage or cost depletion. The cost can only be returned to him by deducting it from the cash consideration, and if this is done it will not constitute a double deduction. The effect of the decision of the Tenth Circuit is to tax petitioner with the cost of his equipment.

4. Under the law and regulations there are only two ways by which the cost of the equipment of an oil and gas lease can be recovered. The first is by way of an offset against the selling price when the property is sold, and the second is through annual depreciation allowances where the property is kept and operated. There is no authority for recovering equipment cost through depletion, either by the percentage of income method or on the cost basis.

5. There is no valid distinction between an oil payment and overriding royalty and the same tax effect should be given to each. The courts have uniformly held that the cost of the equipment is deductible in full from the consideration where the lease is sold for cash and an oil payment. The same rule should be applied where the sale is for cash and an overriding royalty.

6. An oil and gas lease and the equipment thereon are, for income tax purposes, different classes of property. One is depletable; the other depreciable. The cost of each is recoverable by different processes. The cost of depreciable equipment may not be transformed into the cost of the leasehold and recovered through depletion.

7. The partnership sold the equipment outright. It retained no interest or lien of any kind. The Commissioner recognized that ownership of the equipment was in Sylva because he allowed that company to take depreciation on it. The undepreciated cost of the equipment is, therefore, deductible from the consideration in computing the gain on the transaction.

Argument

The Tenth Circuit rested its decision on the decision of the Fifth Circuit in Cullen v. Commissioner, infra. The Fifth Circuit repudiated and reversed its decision in the Cullen case in Hogan v. Commissioner, infra. Accordingly, the Cullen decision is no authority for the holding of the Tenth Circuit.

1. The Circuit Court of Appeals for the Tenth Circuit held that since the lease and the equipment were sold as a unit without any segregation of the consideration being made as between the leasehold and the equipment, the cost of the latter is recoverable through percentage depletion allowances (Sec. 114(b)(3), App. p. 21), and may not be deducted from the cash consideration in computing the gain. Both the Commissioner and the Tenth Circuit Court of Appeals relied on the statement made by the Fifth Circuit Court of Appeals in its decision in CULLEN v. COMMISSIONER, 118 Fed. (2d) 651 (April 1, 1941), that the cost of the equipment on the nine leases with respect to which overriding royalties were retained was recoverable "by percentage depletion allowances." The Fifth Circuit Court of Appeals repudiated and reversed this holding in the case of HOGAN v. COMMISSIONER, 141 Fed. (2d) 92 (Feb. 25, 1944), where it said (in speaking of the equipment involved in the instant case), "equipment cost is recoverable through depreciation allowances and not 'by percentage depletion allowances,' as apparently was inadvertently stated in Cullen v. Commissioner, supra" (App. p. 32). Accordingly, the decision in CULLEN'S case is no authority for the holding of the Tenth Circuit herein.

The lease and the equipment in the instant case were no more sold as a unit than was the lease and equipment in the case of Lewis v. Commissioner, infra. Hence, there is no valid distinction between the two cases and the Tenth Circuit should have followed its Lewis case decision herein.

2. The Tenth Circuit Court of Appeals attempted to distinguish the instant case from its decision in COMMISSIONER v. LEWIS, 132 Fed. (2d) 709 (wherein it held that all of the cost of the equipment was deductible from the cash consideration), on the ground that here the transaction was one in entirety, covering both the oil reserves and equipment; whereas in the LEWIS case, it contends that the equipment was sold separately from the oil reserves. A portion of the facts found by The Tax Court in the LEWIS case are set out in the margin.[2]

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[2] In 1935 the partnership purchased two non-producing oil and gas leases for a total consideration of $120. Upon these leases the partnership placed certain equipment for the production of oil. On March 23, 1937, the partnership sold the two leases for a cash consideration of $150,000 and an oil payment of $125,000, payable out of one-fourth of seven-eighths of any oil produced from the leases. The contract provided in part as follows:

> "4. IT IS FURTHER UNDERSTOOD AND AGREED that for the consideration above named, said Second Party (vendee) shall be entitled to all of the material now in the ground on said aforedescribed premises, as well as the derricks over the wells now producing, or in the course of drilling on said aforedescribed premises, together with the lead-lines, well-head connections, tank battery, separators, and water wells now situated on said aforedescribed premises (Memo Opinion Tax Court, C.C.H. Dec. No. 12257-C).

It will be seen from The Tax Court's findings that the consideration was not segregated as between the leasehold and the equipment, but that for the $150,000 in cash and $125,000 payable out of oil, the partnership sold both the leasehold and the equipment. In the present case, the partnership assigned "all of its right, title and interest in the lease, * * * together with all wells and equipment thereof, including pumps, casing, pipes, tanks, lease house, et cetera." The granting clause of the assignment is set forth in the footnote 3. If the words "for the consideration above named" in the Lewis assignment are substituted for the word "together" in the Choate and Hogan assignment, the instruments would be substantially identical. This at most is a difference in verbiage and we submit that the lease and equipment in the instant case was no more sold as a unit than was the lease and equipment in the LEWIS case, and we believe that no valid distinction exists between the two cases. Accordingly, the Tenth Circuit should have followed its LEWIS case decision herein.

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3. "Now, therefore, for and in consideration of One Dollar ($1.00) and other good and valuable considerations, the receipt of which is hereby acknowledged, the undersigned L. H. Choate and Fred T. Hogan, the present owners of said lease, as hereinabove set out, and all rights thereunder or incident thereto down to the depth of 2750 feet, * * do hereby bargain, sell, assign and convey, subject to all of the terms and conditions, and the reservation of 1/16th overriding royalty in said assignment from Continental Oil Company to Roy R. Brown, all right, title and interest of the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, * * * together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, a Texas corporation, its successors and assigns; * * *"

The cost of the equipment cannot be returned to petitioner through either percentage or cost depletion. The cost can only be returned to him by deducting it from the cash consideration, and if this is done it will not constitute a double deduction. The effect of the decision of the Tenth Circuit is to tax petitioner with the cost of his equipment.

3. The allowance for depletion under Section 114(b)(3) (App. p. 21) is arbitrarily fixed at 27½% of gross income from the property not to exceed 50% of the net (Regs. 101, Art. 23(m)-1(g), App. p. 21). Percentage depletion is allowable whether the owner of the oil producing property has any cost or basis for it or not. Regardless of whether petitioner has any cost for his interest in the retained ⅛th overriding royalty, he will be entitled to 27½% depletion on the gross proceeds from the sale of his share of the oil runs. This percentage will not in anywise be increased by his share of the cost of the equipment and he will never have any of such cost returned to him through the operation of that subsection. He will likewise not receive any return on his capital investment in the equipment through cost depletion for the reason that under the law (Sec. 114(b)(1) and 113(a) and (a)(14), App. p. 22), and the Regulations (Regs. 101, Art. 23(m)-2 and (m)-16, App. pp. 22-23), only the cost or March 1, 1913, value of the lease or property plus the intangible costs of boring the well (if the taxpayer has elected to capitalize intangible development costs) is recoverable through depletion. Consequently, petitioner's share of the cost of the equipment on the lease cannot be added to the cost of his interest in the retained overriding royalty and recovered through depletion. The only way petitioner can have his share of the cost of the equipment returned

to him is by deducting it from the consideration received from the sale of the property. And, for the reasons above stated, if this is done, he will not receive anything akin to a double deduction. The effect of the decision of the Tenth Circuit is to tax petitioner on the cost of his equipment.

Under the law and regulations there are only two ways by which the cost of the equipment of an oil and gas lease can be recovered. The first is by way of an offset against the selling price when the property is sold and the second is through annual depreciation allowances where the property is kept and operated. There is no authority for recovering equipment cost through depletion, either on the percentage or cost basis.

4. Section 111 of the REVENUE ACT OF 1938 provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis which includes cost (App. p. 25). Section 23(m) of the REVENUE ACT OF 1938 (App. p. 25) provides that in the case of mines, oil and gas wells, et cetera, there shall be allowed a reasonable amount for depletion and for depreciation of improvements. Art. 23(m)-18, REGULATIONS 101 (App. p. 25), provides that taxpayers operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion, as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes," et cetera.

Thus it will be seen the law and regulations provide only two methods of returning the cost of the equipment on an oil and gas lease. One is by way of offset against the selling

price when the equipment is disposed of; and the other by way of annual allowances for depreciation as long as the property is retained. There is not now, and never has been, any authority, either in the law or the regulations for returning the cost of the physical equipment of an oil well by way of depletion allowances, and there is no basis in the law or the regulations for the holding of the Tenth Circuit Court of Appeals that the cost of petitioner's equipment is recoverable by percentage depletion allowances.

There is no valid distinction between an oil payment and an overriding royalty and the same tax effect should be given to each. The courts have uniformly held that the cost of the equipment is deductible in full from the consideration where the lease is sold for cash and an oil payment. The same rule should be applied where the sale is for cash and an overriding royalty.

5. It is well established that oil payments and oil royalties are properties of like kind and character. The only difference between the two is that the oil payment is limited in amount, whereas the royalty continues as long as the property produces oil in paying quantities. This is merely a difference in degree or quantity. See STATE, ET AL., v. QUINTANA PETROLEUM CO. (Texas Sup. Ct.), 133 S.W. (2d) 112, and SHEPPARD v. STANOLIND OIL & GAS CO., 125 S.W. (2d) 643 (writ of error refused), in the latter of which the court said:

> "The oil bonus (payment), as we have seen partakes in every particular of the nature of royalty and royalty bonus, except only that its amount is limited. It is analogous to an overriding royalty. *And such it would in fact be if, instead of moving to the lessor, it moved to the lessee under an assignment of the lease.*"

The courts have uniformly held that where an oil and gas lease is sold for cash and an oil payment that the cost of the equipment is deductible in full from the cash consideration and that none of it is apportionable to the reserved oil payment interest. See LEWIS v. COMMISSIONER, supra (Tenth Circuit); COMMISSIONER v. COLUMBIA OIL & GAS CO., 118 Fed. (2d) 459 (Fifth Circuit), affirming 41 B.T.A. 38; CULLEN v. COMMISSIONER, supra (Fifth Circuit); and THOMAS v. PECKHAM, 115 Fed. (2d) 685 (Fifth Circuit).

There is no decision of any court which holds to the contrary. And, as previously stated herein, the Fifth Circuit in COMMISSIONER v. HOGAN, supra, held that the cost of the equipment is deductible from the cash consideration even though the retention is in the form of an overriding royalty. Since, as shown above, there is no difference between an oil payment and overriding royalty, the rule applied by the courts in cases where an oil payment is retained should also be applied if the retained interest is in the form of an override, if, as here, the vendor does not retain any interest in the equipment.

An oil and gas lease and the equipment thereon are, for income tax purposes, different classes of property. One is depletable; the other depreciable. The cost of each is recoverable by different processes. The cost of the equipment may not be transformed into the cost of the leasehold and recovered through depletion.

6. The Commissioner, in the court below, stated that the CULLEN case, which, as previously stated, was later repudiated and reversed by the Fifth Circuit Court in COMMISSIONER v. HOGAN, supra, presented identical facts and should be followed, and contended that when the lease was "leased" to Sylva, the partnership's investment in both lease and equipment "merged" and became cost to it of the retained royalty interest, which cost is returnable through depletion. The court below does not appear to have given any weight to such argument, but in the event the respondent reiterates the argument in this Court, we wish to point out that since the inception of the income tax laws an oil and gas lease and the equipment on the lease have been treated as separate and distinct units of property, the cost of the former being returnable only through depletion allowances and that of the latter only through annual deductions for depreciation. This long-standing treatment accorded to the two distinct units of property alone would seem to be sufficient to refute the contention that the cost of the units could under any circumstances be said to merge, and the cost of one type of property be substituted for or become that of another type. See in this connection the decision of this court in DAKOTA-MONTANA OIL CO. v. U. S., 288 U.S. 459, 53 S. Ct. 435, where the court held that the intangible costs of drilling the hole in the ground is recoverable only through depletion allowances and may not be recovered by way of deductions

for depreciation. It would seem to logically follow from this decision that the reverse would also be true and that the cost of depreciable property cannot be recovered through depletion allowances but can only be recovered through allowances for depreciation.

A merger is said to contemplate the absorption of a lesser interest by a greater, as where a life tenant acquires the fee. The partnership did not acquire any interest to merge with or be absorbed by the 1/8th royalty interest which it retained in the sale to Sylva. Just the opposite is true. The partnership parted with all of its property except the 1/8th royalty, and we fail to see how it could be said that there could have been a merger of the cost of the equipment with the cost of the retained interest.

Moreover, while it is possible for costs of property to be combined or merged for income tax purposes, as where the owner of a one-half interest in an oil and gas lease buys the other half, in which event the cost of each half might be said to combine or merge for cost depletion purposes, it is not possible for the cost of one kind of property to be combined with the cost of another and different kind of property where the cost of each is recoverable through different processes and under different provisions of the law and regulations. As previously pointed out herein, the owner of an oil and gas lease has always been required to recover the cost of his lease through depletion allowances and the cost of his lease equipment through depreciation allowances, and there is no provision which will permit the transformation of the cost of the equipment into the cost of the leasehold and allow the cost of the equipment to be recovered through depletion.

If, in the illustration given above, the taxpayer had acquired the other half interest in the lease equipment in addition to the other half interest in the lease, he would not be permitted under the present law and regulations to charge

what he paid for the half interest in the equipment to his leasehold cost and recover same through depletion allowances. Nor would he be permitted to charge the cost of the other half interest in the lease to the cost of the equipment and recover it through depreciation allowances. This is so because, as previously stated, for income tax purposes the leasehold and the equipment are classified and treated as separate and distinct units of property, the cost of each being recoverable through different and distinct methods.

It seems clear, therefore, that under no circumstances can the cost of the equipment be combined with the cost of the leasehold and recovered through depletion allowances; therefore, there is no merit to the merger contention if respondent sees fit to again advance it in this proceeding.

The partnership sold the equipment outright. It retained no interest or lien of any kind. The Commissioner recognized that ownership of the equipment was in Sylva because he allowed that Company to take depreciation on it. The undepreciated cost of the equipment is therefore deductible from the consideration in computing the gain on the transaction.

7. By the terms of the assignment, the partnership sold an interest in the oil reserves, reserved an overriding royalty of 1/8th of 8 8ths of production, and sold the lease and well equipment outright. The partnership did not retain title, lien, or any kindred interest in the equipment, either expressly or by implication. The partnership completely divested itself of all of its interest in the equipment. After the transaction was completed, the Sylva Oil Company was the owner of all of the equipment. The respondent recognized that ownership was in Sylva because The Tax Court found as a fact (R. 18) that he allowed Sylva to deduct depreciation of $1,674.17 for 1938 and $5,613.35 for the year 1939 after an examination by his agent. Depreciation is allowable only to the owner of the property on which it is claimed. Since it is clear that the partnership disposed of its entire interest in the equipment, the undepreciated cost ($23,090.60) is deductible from the cash consideration of $110,000. Unless the cost is so deducted, the true gain on the transaction will not be reflected and the cost of the equipment will never be returned to the members of the partnership.

Conclusion

The decision of the Circuit Court of Appeals for the Tenth Circuit should be reversed.

Respectfully submitted,

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Appendix

SEC. 114 REVENUE ACT OF 1938:

(b) (3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under Section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23 (m) be less than it would be if computed without reference to this paragraph.

REGULATIONS 101, ART. 23:

(m)-1 (g). "Gross income from the property, as used in Section 114 (b) (3) and (4) and Articles 23 (m)-1 to 23 (m)-28, inclusive, means the amount for which the taxpayer sells (a) the crude mineral product of the property or (b) the product derived therefrom, not to exceed in the case of (a) the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade from which the product sold was derived, before the application of any processes (to which the crude mineral product may have been subjected after emerging from the mine or well) with the exception of those listed below, and before transportation from the place where the last of the processes listed below was applied. If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes minus the costs (including transportation costs) of the processes not listed below. * * *

SEC. 114, REVENUE ACT OF 1938:

(b) (1) Basis for Depletion. The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in Paragraphs (2), (3), and (4) of this subsection.

SEC. 113, REVENUE ACT OF 1938:

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * *

(14) Property Acquired Before March 1, 1913.—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in Subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

REGULATIONS 101, ART. 23:

(m)-2. Computation of depletion of mines, oil and gas wells, and other natural deposits without reference to discovery value or percentage depletion.—The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided in Section 113 (a), adjusted as provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (See Articles 113 (a)-1 to 114-1.) If the amount of the basis as adjusted applicable

to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas. * * *

REGULATIONS 101, ART. 23:

(m)-16. Charges to capital and to expense in the case of oil and gas wells.—(a) Items chargeable to capital or to expense at taxpayer's option:

(1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc. incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and

developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option the cost of drilling nonproductive wells at the option of the taxpayer may be deducted from gross income for the year in which the taxpayer completes such a well or be charged to capital account returnable through depletion and depreciation as in the case of productive wells.

(3) If deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or if capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(b) Recovery of option items, if capitalized:

(1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this article the expenditures for clearing ground, drainage, road making, surveying, geological work,

excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If in exercising these options, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are represented by physical property, are returnable through depreciation. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc. used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

SEC. 111, REVENUE ACT OF 1938:

(a) COMPUTATION OF GAIN OR LOSS—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

SEC. 23. REVENUE ACT OF 1938:

(In computing net income there shall be allowed as deductions):

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

REGULATIONS 101, ART. 23:

(m)-18. Depreciation of improvements in the case of oil and gas wells.—Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under Article 23(m)-16. * * *

(m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Fred T. Hogan, Petitioner, v. Commissioner of Internal Revenue, Respondent. Commissioner of Internal Revenue, Petitioner, v. Fred T. Hogan, Respondent.

United States Circuit Court of Appeals for the Fifth Circuit. No. 10749. February 25, 1944.

Petitions for review of decision of the Tax Court of the United States (District of Texas).

Before Holmes, Waller, and Lee, Circuit Judges.

Lee, Circuit Judge: This case comes to us on separate petitions of Fred T. Hogan, the taxpayer, and the Commissioner of Internal Revenue for a review of a decision of the Tax Court. Both causes were consolidated upon joint motion for

printing the record, briefing, argument and decision. The questions presented for determination are:

1. Was the transfer by Choate & Hogan, a partnership of which taxpayer was a member, of an interest in a producing oil and gas lease and all equipment thereon, for cash and the reservation of an overriding royalty, a sale resulting in a capital gain taxable under Section 117 of the Revenue Act of 1938[1] or a sublease resulting in ordinary income under Section 22(a) of the Act?

2. Did title to the leasehold equipment pass with the interest in the lease; if so, was the depreciated cost deductible from the cash consideration paid?

[*The Facts*]

The facts out of which this litigation grew are as follows: Mrs. M. L. Baker executed, on September 8, 1924, an oil and gas lease in favor of G. A. Tunstill, covering approximately 1250 acres of land situated in Upton County, Texas. The lease provided for the usual one-eighth (1/8) royalty of oil, for one-eighth (1/8) of the value of casinghead gas utilized and for $200 per annum for each gas well from which gas was used off the premises or marketed by lessee. Fred T. Hogan and L. H. Choate, acting for themselves and W. G. Choate, acquired 230 acres of this lease on December 18, 1936, as to all rights thereunder and incident thereto down to the depth of 2750 feet, by mesne assignments out of G. A. Tunstill, the original lessee, subject to one-sixteenth (1/16) overriding royalty in favor of the Continental Oil Company.[2] Hogan and the two Choates

[1] 52 Stat. 447.

[2] On July 7, 1925, Tunstill assigned the lease except as to certain acreage to Marland Oil Company and as a result of the consolidation

formed a partnership under the name of Choate & Hogan, for the purpose of owning, developing, and operating the lease, the profits and losses of said partnership in keeping with the ownership of the lease, to be shared 50% by Hogan and 50% by L. H. Choate and W. G. Choate. The partnership owned and operated the property until August 22, 1938, drilling and completing thereon six producing oil wells. On August 11, 1938, the partnership entered into a contract with McAlester Fuel Company pursuant to which Fred T. Hogan and L. H. Choate, on August 22, 1938, at the request of McAlester Fuel Company, executed, and, upon payment of $110,000, delivered to Sylva Oil Company an assignment reading in part as follows:

> "The undersigned L. H. Choate and Fred T. Hogan, the present owners of said lease * * * do hereby bargain, sell, assign and convey subject to * * * the reservation of 1/16 overriding royalty in said assignment from the Continental Oil Company to Roy R. Brown, all rights, title and interest to the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, * * * at and above the depth of two thousand seven hundred fifty feet from the surface in and under the said 230 acres of land above

---

of that Company with the Continental Oil Company on July 1, 1929, the lease became the property of the Continental Oil Company. On December 3, 1936, Continental Oil Company assigned to Roy R. Brown all of its rights, titles and interest in the lease "so far as said lease covers and affects the oil, gas and casinghead gas, and the oil, gas and casinghead gas rights, at and above the depth of 2750 feet from the surface," as to 230 acres specifically described. Brown agreed in this assignment that "as a part of the consideration * * *, the assignor shall receive, as an overriding royalty, one-sixteenth (1/16) of all the oil, gas and casinghead gas produced, saved and sold" from the assigned premises. On December 18, 1936, Brown conveyed the interest so acquired subject to the terms and conditions of his assignment from the Continental Oil Company to Fred T. Hogan and L. H. Choate.

described, together with all wells and equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage, to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignors herein expressly reserve to themselves, their heirs and assigns and do not assign or convey to assignee herein 1/8th of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company, its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred fifty feet from the surface * * *; such reservation of overriding royalty or share of production to be 1/16th of 8/8ths in favor of L. H. Choate and 1/16th of 8/8ths in favor of Fred T. Hogan. * * * "

The partnership in its return for 1938 allocated $98,454.70 of the cash consideration to the leasehold and the remainder of $11,545.30 to the equipment. It treated the net gain from the transfer of the leasehold of $71,870.92 as a long-term capital gain, taxable to the extent of $47,913.95, and the net loss from the transfer of the equipment of $11,545.30 as an ordinary loss. This gain and loss was divided among the partners in the following proportions:

		Gain	Loss
Fred T. Hogan	1/2	$23,956.98	$ 5,772.65
L. H. Choate	1/8	5,989.24	1,443.16
Lucille Choate	1/8	5,989.24	1,443.16
W. G. Choate	1/4	11,978.49	2,836.33
		$47,913.95	$11,545.30

The Commissioner refused to recognize the assignment as a sale, contending that it was a sublease and that the con-

sideration of $110,000 was a bonus, and computed the gain on the transaction as follows:

"Oil Income"		$110,000.00
Less—Depletion	$30,250.00	
Commissions	3,000.00	33,250.00
Net Income		$ 76,750.00

The Tax Court held: (1) That the partnership was not entitled to treat the assignment as a sale, but must look to depletion for the return of its capital. (2) That title to the equipment passed to Sylva Oil Company under the assignment and the partnership was entitled to an allowance for the unrecovered cost of said equipment. The taxpayer petitions for review of the first holding. The Commissioner petitions for review of the second holding. We shall consider separately the questions presented.

1. The assignment and transfer of a producing oil and gas lease for cash and a reservation of an overriding royalty in some states is the sale of the oil and gas in place, and in others, a sublease. The assignment, therefore, in the present case would be a sale in some states and a sublease in others, dependent upon local law. In applying the income tax statute, however, the Supreme Court has held that technical distinctions of local laws will be disregarded, and the statute will be interpreted so as to apply uniformly.

[*Sublease v. Sale*]

When the owner and operator of a producing oil and gas lease assigns and transfers it for cash and the payment of an overriding royalty, he retains an economic interest in the oil and gas in place which will be depleted by production.

The cash bonus received by him is treated as advance royalty with the same tax incidence. The granting clause in such an assignment is oftentimes written in language used in a sale, and standing alone would effect a sale; but where the granting clause conveys all of the rights of the assignor and is qualified by other parts, parts for instance, reserving in the assignor an overriding royalty, the assignment, for income tax purposes, partakes of the nature of a sublease rather than of a sale and is of the character of transaction with respect to which relief is granted in the Act by the allowance of depletions.

[*Harmel Case Discussed*]

In the case of Burnet v. Harmel, 287 U.S. 103 [3 USTC Par. 990], the Supreme Court, discussing the Texas law which treats an oil and gas lease as a sale of minerals in place, pointed out that nevertheless such a document was a lease instead of a sale within the ordinary conception of the word as used in the "Capital Gains" section of the Revenue Act of 1924, and said (page 106):

It is an incident of every oil and gas lease, where production operations are carried on by the lessee, that the ownership of the oil and gas passes from the lessor to the lessee at some time and the lessor is compensated by the payments made by the lessee for the rights and privileges which he acquires under the lease. But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act. Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time-consuming operation and the payments made by the lessee

to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property. The payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease, and the taxation of the one as ordinary income does not act as a deterrent upon conversion of capital assets, any more than the taxation of the other.

We agree with the Tax Court that the partnership was not entitled to treat the assignment as a sale of a capital asset, but must look to depletion for the return of its capital.

2. We also agree with the Tax Court that title to the equipment passed from the partnership to Sylva Oil Company under the assignment, and that the partnership was entitled to deduct from the cash consideration the depreciated cost of said equipment. The assignment conveyed to Sylva Oil Company not only an interest in a producing oil and gas lease, but all equipment thereon. Under the Act, depletion percentage on the bonus received and the royalty reserved is not a deduction associated with equipment cost. Equipment cost is recoverable through depreciation allowances and not "by percentage depletion allowances," as apparently was inadvertently stated in *Cullen v. Commissioner*.[8] It is only with respect to wasting assets that depletion allowances are made.[9] * * *

We find no error in the opinion and decree of the Tax Court. Its holding is, therefore, affirmed.

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[8] 118 F. (2d) 651, 653 (41-1 USTC, Par. 9364).

[9] 26 U. S. C. A. 23(m).

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No. 93

In the Supreme Court of the United States

OCTOBER TERM, 1944

W. G. CHOATE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute and regulations involved	2
Statement	2
Discussion	3
Conclusion	5

CITATIONS

Cases:	
Cullen v. *Commissioner*, 118 F. (2d) 651	4
Hogan v. *Commissioner*, 141 F. (2d) 92, pending on petition for writ of certiorari, No. 94 this Term	2, 3, 4

593356—44

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 93

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v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 24–34) is not officially reported. The opinion of the circuit court of appeals (R. 79–83) is reported in 141 F. (2d) 641.

JURISDICTION

The judgment of the circuit court of appeals was entered March 13, 1944 (R. 83–84). Motion for rehearing was denied April 8, 1944 (R. 94). Petition for a writ of certiorari was filed May 23, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether a transfer in 1938 of an interest in a producing oil and gas leasehold together with the equipment thereon, for a cash consideration and the retention of an overriding royalty, was a sublease resulting in ordinary income under Section 22 (a) of the Revenue Act of 1938, as the Commissioner contends, or a sale giving rise to capital gain under Section 117 of the Act, as the petitioner contends.

2. Whether the undepreciated cost of equipment accompanying the leasehold may be deducted by the taxpayer from the cash consideration for purposes of computing net income for 1938.

STATUTE AND REGULATIONS INVOLVED

The pertinent sections of the statute and regulations are set forth in the Appendix to our brief in opposition to the petition for a writ of certiorari in *Hogan* v. *Commissioner of Internal Revenue*, No. 94 this Term.

STATEMENT

This case is a companion to *Hogan* v. *Commissioner of Internal Revenue*, No. 94 this Term. The two cases were tried on a single record in the Tax Court, and disposed of by that court in a single opinion. A full statement of the pertinent facts will be found in our brief in opposition to the petition in No. 94. The Tax Court made precisely the same disposition of the claims of

petitioner here as it made of the identical claims of his partner, Fred T. Hogan, the petitioner in No. 94.

In No. 94 the Circuit Court of Appeals for the Fifth Circuit affirmed the decision of the Tax Court on both issues presented, thereby deciding the first question stated above in favor of the Commissioner and the second question stated above in favor of the taxpayer Hogan. The petition therein is limited to the first question. In the instant case, the appeal was taken to the Circuit Court of Appeals for the Tenth Circuit, which affirmed the decision of the Tax Court in favor of the Commissioner on the first question, but reversed the Tax Court's decision in favor of the petitioner on the second question, and accepted the contention of the Commissioner that the unrecovered cost of the equipment could not be deducted from the cash consideration received. The petition for a writ of certiorari herein seeks review of the decision below on both questions.

DISCUSSION

In so far as the petition for a writ of certiorari seeks review of the determination that the transfer of the leasehold constituted a sublease resulting in ordinary income under Section 22 (a) of the Revenue Act of 1938, the petition should be denied. On this issue there is no conflict of authorities, and the decision below rests upon uniformly accepted principles of law established long

since by this Court and by it frequently reiterated. The question is the same as that involved in No. 94, and for a discussion of the pertinent considerations and authorities we refer the Court to our brief in opposition to the petition for a writ of certiorari in that case.

With respect to the proper treatment of the equipment transferred with the leasehold, however, the decision of the Circuit Court of Appeals for the Fifth Circuit in the *Hogan* case is in plain conflict with the decision review of which is here sought. The two circuit courts of appeals have reached diametrically opposite conclusions on the same set of facts. While it is true that the majority opinion below relied upon an earlier Fifth Circuit decision, *Cullen* v. *Commissioner*, 118 F. (2d) 651, and accordingly purported to decide this case in conformity with the view adopted in the Fifth Circuit, the Fifth Circuit Court of Appeals itself in the *Hogan* case declined to follow the *Cullen* case. Since the dissenting judge in the court below referred to the opinion in the *Hogan* case, decided about two weeks earlier, it must be assumed that that opinion was available to the court below, and that the conflict of decisions was deliberate. We are advised that the question is a recurring one, and that although the sum in controversy in this case and the *Hogan* case is not large, there is likelihood of further litigation on the same issue which in the

aggregate may well involve very substantial amounts. Accordingly, on this issue we do not feel justified in opposing the issuance of a writ.

CONCLUSION

If the second question presented by the petition, with respect to which a conflict of authorities exists, is deemed by this Court to be of sufficient importance to warrant the issuance of a writ of certiorari, it is respectfully submitted that the writ should be limited to that question.

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JUNE 1944.

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BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Summary of argument	5
Argument: The taxpayer and his associates are not entitled to deduct the unrecovered cost of the equipment from the bonus received for the sublease	8
Conclusion	29
Appendix	30

CITATIONS

Cases:

Anderson v. *Helvering*, 310 U. S. 404	24
Atlantic Coast Line R. Co. v. *Commissioner*, 81 F. 2d 309, certiorari denied, 298 U. S. 656	15
Burnet v. *Harmel*, 287 U. S. 103	10, 17, 20
Columbia Oil & Gas Co. v. *Commissioner*, 41 B. T. A. 38	25
Columbia Oil & Gas Co. v. *Commissioner*, 118 F. 2d 459	24, 26
Commissioner v. *Fleming*, 82 F. 2d 324	25
Commissioner v. *J. A. O'Shaughnessy, Inc.*, 124 F. 2d 33	16
Commissioner v. *Lewis*, 132 F. 2d 709	24
Commissioner v. *Roeser & Pendleton, Inc.*, 118 F. 2d 462, certiorari denied, 314 U. S. 635, rehearing denied, 314 U. S. 711	24
Commissioner v. *Rowan Drilling Co.*, 130 F. 2d 62	16
Commissioner v. *Terre Haute Elec. Co.*, 67 F. 2d 697, certiorari denied, 292 U. S. 624	15
Commissioner v. *West Production Co.*, 121 F. 2d 9	23
Crile v. *Commissioner*, 55 F. 2d 804, certiorari denied, 287 U. S. 600	12
Cullen v. *Commissioner*, 118 F. 2d 651	23
Gates v. *Helvering*, 69 F. 2d 277	12
Georgia Ry. & Electric Co. v. *Commissioner*, 77 F. 2d 897, certiorari denied, 296 U. S. 601	15
Hardesty v. *Commissioner*, 127 F. 2d 845	16
Herring v. *Commissioner*, 293 U. S. 322	10, 17
Hogan v. *Commissioner*, 141 F. 2d 92	5, 10, 11, 23
Hunt v. *Commissioner*, 135 F. 2d 697	16

623290—44——1

Cases—Continued. Page

Kiesau Petroleum Corp. v. *Commissioner*, 42 B. T. A. 69 .. 16
Lee v. *Commissioner*, 126 F. 2d 825 16
Main & McKinney Bldg. Co. v. *Commissioner*, 113 F. 2d 81, certiorari denied, 311 U. S. 688 23
Meers v. *Frick-Reid Supply Corp.*, 127 S. W. 2d 493 18
Murphy Oil Co. v. *Burnet*, 287 U. S. 299 10, 14
Okmulgee Supply Corp. v. *Anthis*, 189 Okla. 139 19
Orfic Gasoline Production Co. v. *Herring*, 273 S. W. 944 18
Palmer v. *Bender*, 49 F. 2d 316 24
Palmer v. *Bender*, 287 U. S. 551 10, 12, 17, 20, 22, 24, 28
Thomas v. *Peckham Oil Co.*, 115 F. 2d 685 24
Thomas v. *Perkins*, 301 U. S. 655 24, 25
United States v. *Dakota-Montana Oil Co.*, 288 U. S. 459 13
Wisconsin-Texas Oil Co. v. *Clutter*, 258 S. W. 265 18

Statutes:

Revenue Act of 1938, c. 289, 52 Stat. 447:
Sec. 23 30
Sec. 111 30
Sec. 113 30
Sec. 114 21, 30

Miscellaneous:

G. C. M. 22730, 1941–1 Cum. Bull. 214 28
G. C. M. 23623, 1943 Cum. Bull. 313 26, 28
Mertens, Law of Federal Income Taxation, Sec. 12.31 23
Treasury Regulations 101:
Art. 23(m)–10 32
Art. 23(m)–18 15, 33

In the Supreme Court of the United States

OCTOBER TERM, 1944

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 13–23) is not officially reported. The opinion of the Circuit Court of Appeals (R. 43–47) is reported at 141 F. 2d 641.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 13, 1944 (R. 47). Motion for rehearing was denied April 8, 1944. (R. 53.) Petition for a writ of certiorari was filed on May 23, 1944 (R. 55), and was granted on October 9, 1944 (R. 54), limited to the second question pre-

sented by the petition for the writ. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Taxpayer and his partner during the tax year transferred the working interest in an oil and gas lease including the fixed equipment, retaining an overriding royalty and receiving a cash bonus. In determining net income for the year of the transaction may the partners, who have thus retained a share in production, treat the bonus as a tax-free return of capital to the extent of their undepreciated equipment cost, or must the entire bonus be considered ordinary income subject to depletion?

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra*, pp. 30–33.

STATEMENT

The material facts as found by the Tax Court (R. 14–21) may be summarized as follows:

In 1924 a Mrs. Baker executed for a cash consideration and a retained one-eighth royalty an oil and gas lease on land she owned in fee in Upton County, Texas (R. 14). On December 18, 1936, by mesne assignments the lease (insofar as it covered and affected oil and gas to the depth of 2,750 feet and subject to an overriding royalty

of one-sixteenth of the gross production) was acquired by a copartnership known as "Choate & Hogan," of which the taxpayer was a member (R. 15). The partnership drilled six producing wells on the leased land and operated the property until August, 1938 (R. 16).

On August 11, 1938, the partnership contracted in writing (R. 16–17, 36–40) to assign its interest in the leasehold,[1] save and except an overriding one-eighth royalty, for a cash consideration of $110,000. By an instrument of assignment (R. 9–10) executed on August 22, 1938, pursuant to the contract the partnership did "bargain, sell, assign and convey" all its right, title and interest in the Baker lease (i. e., to the depth of 2,750 feet)—

> together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, * * * save and except that assignors herein expressly reserve to themselves * * * and do not assign or convey * * * 1/8 of 8/8ths of all oil and gas and casinghead gas which may be produced and saved * * * from the aforesaid land * * *.[2]

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[1] The partnership had a thirteen-sixteenths interest in the total production at the time.

[2] One-half of the partners' overriding royalty was reserved in the name of Fred T. Hogan and the other one-half in the

By a letter from Sylva Oil Company to one of the partners, executed on the date of the assignment, it was specified that Sylva was not purchasing unaffixed or movable equipment, but was "only acquiring the personal property actually used and attached to such producing wells on the lease," together with the house on the lease (R. 17.)

At the date of the transaction with Sylva Oil Company the undepleted cost to the partnership of its thirteen-sixteenths interest in the Baker lease was $23,583.78 and the undepreciated cost of the fixed equipment was $23,090.60 (R. 18).

In its income tax return for 1938 the partnership treated the transaction with Sylva as a sale (R. 18–19). It allocated $11,545.30 of the cash payment (exactly half its remaining cost) to the fixed equipment, as consideration received for the latter, and consequently claimed a loss of $11,545.30 on the equipment. The partnership then allocated the balance of the cash, or $98,454.70, to the leasehold and, after deducting its cost, less depletion theretofore sustained, plus commissions,[3] reported a net capital gain of $71,870.92 from this phase of the transaction. The partners reported their respective distributive shares of partnership net income accordingly (R. 19).

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name of taxpayer's brother, L. H. Choate, acting for himself and the taxpayer (R. 16–17). Thus taxpayer remained entitled to one-thirty-second of the total production.

[3] The commission paid was $3,000 (R. 20).

Upon audit of the partnership return the Commissioner held the transaction a sub-lease and that the $110,000 bonus less commission was taxable as ordinary income, subject to the deduction of percentage depletion[4] in the amount of $30,250[5] (R. 19–20).

The Tax Court held that the equipment was sold absolutely and that the taxpayer was entitled to an allowance against the bonus for the unrecovered cost of the equipment in computing his taxable income for the year 1938, but otherwise upheld the Commissioner's determination (R. 21–23). The Circuit Court of Appeals reversed, in so far as the Tax Court had reversed the Commissioner, and thereby sustained the Commissioner's determination *in toto* (R. 43–47)

In the companion case of the taxpayer's partner, *Hogan* v. *Commissioner,* 141 F. 2d 92, the Circuit Court of Appeals for the Fifth Circuit on February 25, 1944, affirmed the decision of the Tax Court in all respects, and thus created a conflict of decisions with respect to the proper treatment of the equipment costs.

SUMMARY OF ARGUMENT

The rule for which taxpayer contends is based upon the assumption that the parties intended a

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[4] Depletion of 27½ per cent on $110,000 is $30,250.

[5] Thus the Commissioner determined that the partnership realized ordinary income in the amount of $76,750 in 1938 from the transaction with the Sylva Oil Company (R. 20).

separate cash sale of the equipment. This assumption is contradicted by the record, it appearing that no part of the bonus was in fact paid for the equipment. While it is recognized that the case may be decided upon this narrow ground, the Government is contending for a broader rule. This leasehold with its six fully equipped wells constituted an operating property. In transferring that property subject to the reserved one-eighth interest in its gross output, the partnership retained not only an economic interest in the oil in place measured by a share of production, but also a right, recognized by the courts, to have the production equipment continued in use as an operating plant as long as the wells were capable of producing oil. A taxpayer retaining such an interest may not avoid the tax consequences of the transaction by purporting to make a separate sale of the equipment required for production. The case is similar to that of an owner or lessee of improved real estate who leases or subleases the land and at the same time purports to sell the building for cash. Such a "sale" will not be recognized for tax purposes, the cash payment being taxable as rent.

The oil in the ground has been characterized by this Court as a "reservoir of capital investment of the parties." Immediately prior to the transaction of August 22, 1938, the partnership's capital investment in this "reservoir" was composed of

its undepleted leasehold cost and the undepreciated cost of the equipment installed in the wells. In its changed relationship to the property resulting from the transaction this capital investment was converted into a royalty interest or right to share in the oil or its proceeds, payable partly in advance by way of the bonus, and the capital cost of this interest was recoverable only through depletion. If the partnership had not accepted a bonus but instead had reserved a larger royalty, a common arrangement in the oil industry, it is incontrovertible that the partners' aggregate investment in the property, including the equipment cost, would have remained as the cost basis of the royalty interest and would be recoverable only through the depletion allowance. The payment of the bonus or advance royalty did not alter the character of the transaction any more than an unusually large rental payment in the first year alters the character of an ordinary lease.

The taxpayer's argument that the cost of physical equipment may not under the law be recovered through depletion fails to take into account the changed relationship of the partnership to the property resulting from the transaction which altered the nature of its interest. After the transfer its investment was no longer in leasehold and equipment as such, but was an economic interest in an oil producing enterprise, an interest meas-

ured by the production of oil, a depletable interest. The cost of that interest was what the partnership had put into it, its contribution to the reservoir of capital investment, measured by the remaining cost of its original investment in the leasehold and equipment.

ARGUMENT

THE TAXPAYER AND HIS ASSOCIATES ARE NOT ENTITLED TO DEDUCT THE UNRECOVERED COST OF THE EQUIPMENT FROM THE BONUS RECEIVED FOR THE SUBLEASE

Immediately prior to August 22, 1938, the partnership of which taxpayer was a member was the holder of a thirteen-sixteenths operating or working interest in an oil producing property, acquired by assignment. The partnership had drilled six wells on the property, which were producing oil, and had installed in these wells casings, pumps, piping and possibly other equipment. The partnership's undepleted leasehold cost was $23,583.78. The undepreciated cost of the equipment was $23,090.60. It does not appear how this latter cost was distributed among the several items of equipment, but it is fair to assume that a very substantial part of the cost was attributable to the casings, which could not be removed without destroying the wells.[6] The rest of the equipment

[6] Casings are ordinarily cemented into place; the lower part of the casing cannot be removed at all and the removal of the upper part above the cement backing will destroy the well.

was attached to these producing wells and was necessary for their continued operation.

Pursuant to a contract dated August 11, 1938, the partnership on August 22, 1938, executed an instrument (R. 8–12) transferring the working interest to the Sylva Oil Company. This transaction was of a type common in the oil industry. The partnership reserved a one-eighth royalty interest, "1/8 of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company" (R. 10). The company paid a cash bonus of $110,000. It agreed to continue the development of the property (R. 10). By the instrument of transfer, which is titled "Assignment of Oil and Gas Lease", the partnership purported to transfer, subject to the reserved royalty, all its leasehold rights (R. 10)—

> together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises * * *.

This language respecting the equipment was qualified by a letter of even date with the assignment in which the company stated (R. 17) its understanding that it was "only acquiring the personal property actually used and attached to such producing wells on the lease," besides the house on the lease.[7]

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[7] The August 22, 1938, letter is not reprinted in the record as it comes to this Court. The findings of the Tax Court (R. 17) quote the important parts of the letter.

The issue now before this Court concerns only the equipment.[*] The taxpayer contends that as to the equipment this was a closed transaction, an outright sale for cash, and that to the extent of the undepreciated cost of the equipment the cash bonus must as a matter of law be considered as paid for the equipment and so recovered tax free as a return of capital. This contention is based upon the assumption that the parties intended a separate cash sale of the equipment. This assumption is contradicted by the record. The instrument of assignment which refers to the equipment *makes no reference to the bonus.* The bonus was paid pursuant to a preliminary contract dated August 11, 1938 (R. 36–40), under which the partnership "proposes to execute and deliver an Assignment of such Oil and Gas Lease, hereinabove described" (R. 37) and in which it is provided that the "consideration to be paid Seller by Buyer is the sum of One Hundred Ten Thousand Dollars ($110,000.00) in cash, upon the de-

[*] So far as the leasehold is concerned, the transaction was not a sale, and the proceeds of the royalty and bonus paid for the leasehold were ordinary income subject to depletion and not a return of capital. The court below and the Circuit Court of Appeals for the Fifth Circuit, which decided the companion case of *Hogan* v. *Commissioner*, 141 F. 2d 92, have so held, affirming the Tax Court, in accordance with well-settled principles announced by this Court (*Burnet* v. *Harmel*, 287 U. S. 103; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Palmer* v. *Bender*, 287 U. S. 551; *Herring* v. *Commissioner*, 293 U. S. 322) and this Court on October 9, 1944, denied certiorari with respect to this issue.

livery of proper assignment of Oil and Gas Lease" (R. 39). This contract *makes no reference to the equipment*, the bonus being described as the consideration to be paid for the leasehold.

The taxpayer is accordingly asking that there be invoked here a wholly artificial rule of law, a rule which would compel the Commissioner for tax purposes to treat any cash bonus paid in connection with the transfer of a developed oil property as *ipso facto* paid upon a sale of the equipment, to the extent of its undepreciated cost, and so to permit the latter to be recovered tax free, even in contradiction of the actual contract which the parties have made. Although the Tax Court here adopted this view, as did the Circuit Court of Appeals for the Fifth Circuit in deciding the companion case of *Hogan* v. *Commissioner*, 141 F. 2d 92, we submit that this contention was correctly rejected by the court below in the instant case.

While we recognize that this case may be decided upon the narrow ground that according to the record no part of the bonus was as a matter of fact paid for the equipment, the Government is contending for a broader rule. This leasehold, consisting of an interest in oil bearing lands, together with its six fully equipped producing wells, constituted an operating property. In transferring that property subject to the reserved one-eighth interest in its gross output, the partnership retained not only an economic interest in the oil

in place measured by a share of production, but also a right, implicit though not expressed in the contract, to have the production equipment continued in use as an operating plant as long as the wells were capable of producing oil in commercial quantities. A taxpayer retaining such an interest should not at the same time be permitted to avoid the tax consequences of the transaction by purporting to make a separate sale of the equipment.[9]

The case does not differ in substance from that of the owner or lessee of improved real estate who leases or subleases the land and at the same time purports to "sell" the building. Such a "sale" will not be recognized for tax purposes, and the stated consideration for the building is taxable as rent and is not a return of capital, notwithstanding that such consideration may be paid in a lump sum at the time the lease is executed and pursuant to a separate contract of sale. *Gates* v. *Helvering*, 69 F. 2d 277 (C. C. A. 8th); *Crile* v. *Commissioner*, 55 F. 2d 804 (C. C. A. 6th), certiorari denied, 287 U. S. 600.

This Court has referred to the oil in the ground as "a reservoir of capital investment of the several parties." *Palmer* v. *Bender*, 287 U. S. 551, 558.

[9] A different case would of course be presented if the equipment were not attached to or closely associated with the wells, but consisted of movables not necessary to the contemplated continued use of the property, or if the wells were exhausted and the equipment were sold at its salvage value.

Immediately prior to the transaction of August 22, 1938, the partnership's capital investment in this "reservoir" was $46,674.38, the total of its undepleted leasehold cost and the undepreciated cost of the equipment installed in the wells. Both items of cost, the cost of the license to produce the oil together with any capitalized exploration and drilling costs, and the cost of the fixed equipment required for its production, represented an investment in the oil in place, just as the cost of a building represents an investment in the real property upon which it is erected. Indeed, the relationship is even closer in the case of the operating oil property. The value of the fixed equipment is peculiarly dependent upon the petroleum deposit. Exhaustion of that deposit reduces a substantial part of the equipment to a salvage value. And removal of equipment necessary for the continued extraction of oil impairs the interest in the oil deposit.

Had the partnership kept the property, its investment would have been returned to it tax free through depletion and depreciation allowances over the productive life of the property. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459. Alternatively, the investment might have been sold outright and the entire cost basis recovered tax free out of the proceeds of the sale. The partnership did not elect to proceed in either of these ways. It chose rather to retain its investment

in the property in the form of a royalty (payable partly in advance by way of the bonus)[10] while transferring to others the burdens and the benefits of the working interest. In the partnership's changed relationship to the property its capital investment in leasehold and equipment was converted into a royalty interest, a mere right to share in the oil or its proceeds, and the capital cost of this interest should be recoverable only through the depletion allowance.

The contention of the Government may be illustrated by supposing that no bonus had been paid[11] or that the partnership had retained, not a one-eighth royalty plus bonus, but a larger royalty, say one-fourth, and no bonus. Transactions of this type, where only a royalty is reserved, are also common in the oil industry. The tax consequences of such a transaction are clear. The investment in the property represented by leasehold and equipment costs would remain as the cost basis of the royalty interest and would be recoverable only through the depletion allowance, the partnership's resulting capital asset in the new relationship being merely a right to share in

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[10] *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299.

[11] On the basis of the record this need not be considered an hypothetical case, since the bonus was paid under the contract of August 11, 1938, as the consideration for the leasehold, and so far as the equipment is concerned it is as though no bonus had been paid.

the oil as produced or its proceeds.[12] If the partnership had been an outsider not theretofore interested in the property and had contributed to the enterprise depreciable equipment to be installed in the wells, in return for a royalty, an oil-payment right or other form of economic interest, its cost represented in the equipment would

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[12] The several possible alternatives to this treatment require only to be stated to be rejected:

1. That the equipment has been disposed of without consideration and at a total loss. Clearly the transaction as a whole did not result in a loss and the magnitude of the royalty interest may be attributed in no small part to the fact that this was a transfer of developed property.

2. That the equipment has been sold on an installment sale basis. But no price, installment or otherwise, has been fixed; the royalty payments are measured by production and without reference to the equipment.

3. That the partnership is entitled to continue to take depreciation in respect of the equipment. This would involve the retention of a share in the working interest and a correlative responsibility for the upkeep of the equipment. See Treasury Regulations 101, Article 23 (m)-18 (Appendix, *infra*), in which the depreciation allowance is restricted to taxpayers "operating oil or gas properties"—the assignee in the instant case. Compare cases holding that a lessor is not entitled to depreciation where the lessee has assumed full responsibility with respect to the maintenance of the property. *Georgia Ry. & Electric Co. v. Commissioner*, 74 F. 2d 897 (C. C. A. 5th), certiorari denied, 296 U. S. 601; *Commissioner v. Terre Haute Elec. Co.*, 67 F. 2d 697 (C. C. A. 7th), certiorari denied, 292 U. S. 624; *Atlantic Coast Line R. Co. v. Commissioner*, 81 F. 2d 309 (C. C. A. 4th), certiorari denied, 298 U. S. 656.

None of these alternatives, it is submitted, is in keeping with realities of the transaction.

be treated as the acquisition price of an investment in the oil in place, recoverable solely through the depletion allowance. *Commissioner* v. *Rowan Drilling Co.*, 130 F. 2d 62, 64–65 (C. C. A. 5th); *Lee* v. *Commissioner*, 126 F. 2d 825 (C. C. A. 5th); *Hardesty* v. *Commissioner*, 127 F. 2d 843 (C. C. A. 5th); *Hunt* v. *Commissioner*, 135 F. 2d 697 (C. C. A. 5th); *Kiesau Petroleum Corp.* v. *Commissioner*, 42 B. T. A. 69. See also *Commissioner* v. *I. A. O'Shaughnessy, Inc.*, 124 F. 2d 33 (C. C. A. 10th). These cases involved drilling contractors or equipment dealers who had drilled or equipped wells for others in return for oil-payment rights. It was held that the cost of the equipment or the expense incurred by the driller must be capitalized as the cost of the oil-payment right, to be recovered through the depletion allowance. The driller or party furnishing equipment is considered as having made an investment in the oil in place and it is immaterial that that investment is represented by his cost of depreciable property or by other items of cost which would ordinarily be deductible as business expense. In the case at bar the partnership has likewise made a contribution to the enterprise in the form of depreciable equipment and, like the driller or equipment dealer, has emerged with a royalty interest the cost of which, although traceable in part to the equipment, is recoverable only through the allowance for depletion.

The payment of the bonus, even if it had been treated by the parties as the consideration for the equipment, would not change the essential nature of the contract. So far as the leasehold is concerned it is settled law that the "payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease." *Burnet* v. *Harmel*, 287 U. S. 103, 106. And this is true whether the bonus is paid to the original lessor, as in the *Harmel* case, or to an assignor of the leasehold estate. *Palmer* v. *Bender*, 287 U. S. 551. "A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income." *Herring* v. *Commissioner*, 293 U. S. 322, 324. It must be taken as established in this case that the partnership did not sell but retained its investment in the leasehold in the form of a share in the oil or its proceeds, the income from which was to be received partly in advance by way of the bonus and partly by way of royalty payments measured by one-eighth of production.

The same principles apply to the equipment. This transaction from the point of view of both parties was founded upon the continued production of oil. The entire value of the partnership's retained royalty depended upon such production, and the production of oil unquestionably depended

in part upon the use of the equipment.[*] It was implicit in this contract that the assignee, the holder of the working interest, should continue to use the equipment to produce the oil in which the partnership was to share. Under these circumstances, whatever "title" the assignee may have acquired by virtue of the assignment, it seems clear that the partnership retained an interest in the equipment as long as the wells continued to produce. Such an interest has been recognized and given effect by the courts. In *Orfic Gasoline Production Co.* v. *Herring*, 273 S. W. 944 (Texas Civ. App.), the Texas court, although holding that the plaintiff, an assignee of the lease, had acquired title to the casing, declined to permit its removal "so long as the well is a producing well." We quote from the opinion (p. 945):

> So long as the well is a producer, neither the owner of the well nor the owner of the land would have a right to draw the casing and thereby destroy the well. Since all parties who are interested in the property have an interest in the well, no one would have a right to do any act that would destroy the rights of the co-tenants or co-owners of the property.

See also *Wisconsin-Texas Oil Co.* v. *Clutter*, 258 S. W. 265, 267 (Texas Civ. App.); *Meers* v. *Frick-*

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[*] The relative importance of the six producing wells to the enterprise as a whole is indicated by the fact that the assignee drilled only four additional wells (R. 18).

Reid Supply Corp., 127 S. W. 2d 493, 498 (Texas Civ. App.). And in *Okmulgee Supply Corp.* v. *Anthis*, 189 Okla. 139, the Oklahoma court enjoined the removal of equipment by a purchaser thereof. The court stated (p. 141) that—

> the attempted removal of equipment necessary for the operation of the wells was a violation of the rights of those plaintiffs who as owners of interests in the mineral rights occupied the position of lessors.

As we have stated, the record does not show how the partnership's equipment cost is broken down between the six sets of casings and the rest of the equipment, and it may fairly be assumed that the casings represented the greater part of the cost. Their removal would destroy the wells and it is clear that the partnership retained a sufficient interest by virtue of its royalty to prevent such removal as long as the wells continued to produce. The rest of the equipment was "attached to such producing wells" and, while its removal might not destroy the wells, its continued use was necessary for the continued production contemplated by the contract. We would make no distinction between these two classes of property.

It is immaterial that such equipment may be classed as "trade fixtures" which do not become a part of the real estate but may be removed (so far as physically removable) by the holder of the leasehold when the wells cease to produce,

that "title" to the equipment may have vested in the assignee, or that the partnership may have retained no reversionary interest in respect thereof. Cf. *Burnet* v. *Harmel*, 287 U. S. 103; *Palmer* v. *Bender*, 287 U. S. 551. We quote from the opinion of this Court in the latter case (p. 557):

> Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.

The decisive consideration is the fact that the leasehold and the fixed equipment of the six wells constituted an operating property which was intended by the parties to produce (along with any new development) the oil in which the partnership was to share.

The taxpayer attacks the decision below on several grounds. It is argued that the cost of physical equipment is recoverable in only two ways, through the depreciation allowance or as the proceeds of an outright sale, and that there is no authority for its recovery by way of depletion. This argument fails to take into account the changed relationship of the partnership to the property and the altered form of its interest.

After the assignment it was no longer the owner of physical equipment used in its trade or business and was of course not entitled to further depreciation; nor had it sold the equipment outright any more than it had sold the leasehold. Its investment after the transfer was no longer an investment in leasehold and equipment as such but was an economic interest in an oil producing enterprise, an interest measured by the production of oil, a depletable interest. The cost of that interest was what the partnership had put into it, its contribution to the reservoir of capital investment measured by the remaining cost of its original investment in the leasehold and equipment.

It is argued that unless the cost of the equipment is recovered out of the bonus payment as a return of capital, the taxpayer can never recover such cost. This is not true. As we have seen, the equipment cost is included as part of the cost of the partnership's resulting depletable interest, and to the extent that such cost is not recovered through percentage depletion it will be recovered through cost depletion, the minimum annual allowance. Section 114 (b) (3), Revenue Act of 1938 (Appendix, *infra*). It will be observed in this connection that under the Commissioner's computation which was sustained by the court below the partnership was allowed depletion against the bonus in the amount of $30,250 (R. 20) for the taxable year of the assignment. This

was sufficient to return almost two-thirds of its investment in leasehold and equipment combined, without regard to the additional cost or percentage depletion allowable in subsequent years against the royalty payments.[14]

It is argued further that the treatment of the bonus payment as a capital item in the assignee's accounting is inconsistent with its treatment as ordinary income subject to depletion in the hands of the partnership. It is true that, in accord with the practice of the industry and of the Commissioner, the Sylva Oil Company on its books set up the bonus as its cost of the leasehold and equipment and allocated this cost between the several items so acquired (R. 18). This treatment of the bonus as a capital item from the point of view of the assignee-payor has never been considered inconsistent with or as casting doubt upon the rule firmly established by the decisions of this Court[15] that a bonus so paid is ordinary income to the assignor-payee. The same principles apply to the treatment of a bonus in the taxation of lessor and lessee under an ordinary

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[14] Under the rule now contended for by the taxpayer, the partnership would recover its equipment cost, $23,090.60, tax free, and in addition would be entitled in the taxable year to a depletion allowance of $23,075.08 (27½ percent of the net bonus after deducting the equipment cost), a total tax free allowance of $46,165.68, substantially equivalent to its entire capital investment, while retaining the royalty interest upon which percentage depletion (computed without regard to cost) will be allowable in subsequent years.

[15] *Palmer* v. *Bender*, *supra*, and like cases.

leasing transaction. *Main & McKinney Bldg. Co.* v. *Commissioner*, 113 F. 2d 81 (C. C. A. 5th), certiorari denied, 311 U. S. 688. See 2 Mertens, Law of Federal Income Taxation, Sec. 12.31:

> It does not follow, except perhaps logically, that bonuses which are income to the lessor in the year of receipt or accrual are deductible by the lessee who pays them in the year paid or incurred. * * * Such payments, as regards the lessee, are considered to be capital expenditures, * * *.

There is a dearth of authorities on the issue involved in this case. The court below followed *Cullen* v. *Commissioner*, 118 F. 2d 651 (C. C. A. 5th), the only prior case on the point.[16] But in deciding the case which is companion to the instant case, *Hogan* v. *Commissioner*, *supra*, the

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[16] *Commissioner* v. *West Production Co.*, 121 F. 2d 9 (C. C. A. 5th), is a companion to the *Cullen* case. The Tax Court in the instant case (R. 22) thought to distinguish the *Cullen* case factually on the ground that the contracts there made no mention of physical equipment. This distinction is not borne out by the record. The granting clause of the assignment, it is true, did not mention the equipment but the *habendum* clause (*Cullen* record 190) did refer to equipment as follows:

"To Have and to Hold said undivided interest in and to the oil and gas mineral leases above described and each of them, * * *, together with a one-half (½) undivided interest in and to all oil wells, gas wells and other wells situated thereon and all wells drilling thereon, and a one-half (½) undivided interest in all physical equipment, fixtures, drilling rigs and other personal property situated thereon * * *."

Circuit Court of Appeals for the Fifth Circuit declined to follow its earlier decision. In *Palmer* v. *Bender*, *supra*, as in the instant case, the subject of the transfer was developed property,[17] and while no question was raised in that case as to whether a part of the cash bonus should be attributed to physical equipment, this Court concluded that the whole bonus payment was depletable. No part of the bonus was treated as proceeds from the sale of equipment.

The cases involving cash payments accompanying the reservation of oil-payment rights[18] are clearly distinguishable. An oil-payment right is a right to share in the oil or its proceeds until a specified quantity of oil or sum in dollars is received. Cf. *Thomas* v. *Perkins*, 301 U. S. 655; *Anderson* v. *Helvering*, 310 U. S. 404. An oil-payment right is considered a reserved interest in the oil in place, and is subject to depletion, but the transfer of an oil lease reserving only an oil-payment right has never been characterized as a sublease and the accompanying cash payment is not advanced royalty but the proceeds of a sale

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[17] The assignment to the Gulf Refining Company (*Palmer* v. *Bender*, *supra*) included "the eleven (11) oil wells on said property, all equipment thereto annexed and attached. * * *." See opinion of District Court (W. D. La.), 49 F. 2d 316, 319.

[18] *Commissioner* v. *Lewis*, 132 F. 2d 709 (C. C. A. 10th); *Columbia Oil & Gas Co.* v. *Commissioner*, 118 F. 2d 459 (C. C. A. 5th); *Commissioner* v. *Roeser & Pendleton, Inc.*, 118 F. 2d 462 (C. C. A. 5th), certiorari denied, 314 U. S. 635, rehearing denied, 314 U. S. 711; *Thomas* v. *Peckham Oil Co.*, 115 F. 2d 685 (C. C. A. 5th).

pro tanto of the taxpayer's interest, a sale of the assignor's interest less the oil-payment interest retained. *Commissioner* v. *Fleming,* 82 F. 2d 324 (C. C. A. 5th); *Thomas* v. *Perkins, supra.* In such cases, where no royalty interest is retained and where the transaction is regarded as a sale of all but the retained interest, the taxpayer is permitted to recover the undepreciated cost of his equipment out of the cash payment. (See cases cited in fn. 18.) The soundness of these latter cases may be questioned; there appears to be no basis for the assumption that the equipment even in the oil-payment cases should be treated as wholly sold where the assignor has retained a depletable interest in the producing enterprise. The sounder rule would require the allocation of the equipment cost as well as the leasehold cost between the part sold and the part retained in proportion to the respective values of the two parts.[19]

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[19] The following illustration is based upon the figures in *Columbia Oil & Gas Co.* v. *Commissioner, supra,* footnote 18, which appears in the opinion of the Board of Tax Appeals in that case, 41 B. T. A. 38, 47:

Assignor's costs:		
Leasehold	$133,307.78	
Equipment	246,590.00	
Total cost	$379,897.78	
Cash payment by assignee		$550,000
Oil-payment right—$350,000 valued at		175,000
Total value of property at time of sale		$725,000

The total cost, including the equipment, should be apportioned between the part sold (valued at $550,000) and the

In acquiescing in the rule of the decided cases the Chief Counsel of the Bureau of Internal Revenue in G. C. M. 23623, 1943 Cum. Bull. 313, emphasized the distinction between the two types of cases:

> Care should, of course, be exercised in confining the application of the stated rule to those cases in which the assignment effects a sale, as differentiated from a transaction

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part retained (valued at $175,000) in proportion to their respective values, thus:

$\frac{550,000}{725,000} \times \$379,897.78 = \$288,198.32$ (cost of part sold)

$\frac{175,000}{725,000} \times \$379,897.78 = \$91,699.46$ (cost of part retained, recoverable through depletion)

Capital gain on part sold:

Sales price	$550,000.00
Less cost	288,198.32
Profit	$261,801.68

The leasehold and equipment should be treated as a unit as to which the assignor has retained, by virtue of the oil-payment right, a depletable economic interest dependent upon production.

The court in the *Columbia* case and the other cases cited in footnote 18 held however that in such cases the equipment is to be treated as sold outright and its cost deducted in full from the cash payment as a return of capital. No part of the equipment cost was charged to the retained oil-payment right.

In no case has a loss been allowed in connection with such a transaction. If there were no cash payment or if the cash payment were insufficient to cover the equipment cost the unrecovered cost of the equipment would become a part of the cost of the oil-payment right and would accordingly be recoverable only through depletion. (See G. C. M. 23623, 1943 Cum. Bull. 313.) This demonstrates the illogical and arbitrary nature of the rule of the *Columbia* case.

> in which the assignor or sublessor retains a royalty interest throughout the productive life of the property, * * *.

The rule for which we contend comports with the realities of the transaction, which contemplates the continued use of the equipment for the production of the oil in which the partnership is to share. The contrary rule would, as the court below points out in its opinion, permit of manipulation by taxpayers in the reduction of their tax liabilities. The rule for which the taxpayer contends presupposes a separate sale of the equipment for cash, and the logic of this rule would seem to compel the allowance of a loss if the cash were insufficient to return to the taxpayer his full undepreciated cost.[20] Transactions of this sort are wholly flexible in regard to the amount of the cash payment or bonus, and will vary between the extremes of no cash with a large royalty and practically all cash with a very small royalty. The determining factor from the point of view of the assignor is the extent to which he is prepared to speculate or continue his speculation in the production of the oil, and there is no neces-

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[20] This, upon the theory that if the partnership had received a cash bonus of less than $23,090.60, it would have sustained a deductible loss. See the dissenting opinion of Phillips, C. J., in the court below (R. 46):

"It is my opinion that there was a sale of the equipment. * * * If this be true, then W. G. Choate was entitled to deduct * * * one hundred per cent of the loss if it was sold for an amount less than the depreciated cost."

sary relationship between the amount of the bonus and the assignor's investment in either leasehold or equipment, or both combined. Yet if lessors and assignors of oil leases are permitted, as the lessor or sublessor of improved real estate is not, to bargain separately for the sale of the fixed equipment, the bargain will inevitably be affected by the fact that the proceeds allocated to the equipment will be received tax free as a return of capital with any profit taxed at capital gain rates.

The rule contended for in the instant case has been followed in practice by the Commissioner, though it is embodied in no regulation or published ruling except inferentially in the Chief Counsel's memorandum quoted above.[21] The rule is implicit, however, in the principles announced by this Court in *Palmer* v. *Bender, supra,* and subsequent cases (p. 558):

> Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced.

The partnership has merely changed its relationship to the oil in place, the reservoir of capital

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[21] G. C. M. 23623, 1943 Cum. Bull. 313. See, however, the general discussion of the status of oil and gas leasing transactions in G. C. M. 22730, 1941-1 Cum. Bull. 214.

investment. An investment formerly represented by the leasehold rights and depreciable physical property is now represented only by a depletable royalty interest, an interest measured by a share of the oil produced and therefore dependent upon the continued operation of this producing property.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted,

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DECEMBER 1944.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion allowable under this subsection, see section 114 (b)(3), (3) and (4).)

(n) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of gain or loss.*—The gain from the sale or other disposition of

property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less that the amount allowable) under this Act or prior income tax laws. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose

of determining the gain upon the sale or other disposition of such property.

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 23 (m)-10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*— * * *

* * * * *

(*d*) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof * * * but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

* * * * *

ART. 23 (m)-18. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 23 (m)-16. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1944

SUPREME COURT OF THE UNITED STATES.

No. 93.—October Term, 1944.

W. G. Choate, Petitioner, vs. Commissioner of Internal Revenue. } On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit.

[January 29, 1945.]

Mr. Justice Douglas delivered the opinion of the Court.

In 1936 Choate and Hogan, a partnership of which the petitioner was a member, acquired an oil and gas lease. They drilled six producing wells on the leased land and operated the property until August, 1938. At that time they sold to Sylva Oil Co. for a cash consideration of $110,000 all their right, title and interest in the lease "together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection" with the premises. But they expressly reserved to themselves "1/8 of the 8/8ths of all oil and gas and casinghead gas which may be produced and saved" from the land. Thereafter Sylva Oil Co. drilled additional wells and operated the lease. Choate and Hogan in their partnership return for 1938 reported the transaction as a sale. Respondent in his deficiency notice ruled that the transaction constituted a sublease. The Tax Court took the same view, holding that the partners must look to depletion for the return of their capital. It held that the principle of recovery by depletion was applicable where a royalty interest was retained and that a cash bonus was to be regarded as in the nature of an advance royalty. It held, however, that there had been an absolute sale of the equipment, that its cost was not recoverable by depletion, and that the partners were entitled to an allowance for the unrecovered cost of the equipment transferred. The Commissioner challenged the latter ruling—in the Circuit Court of Appeals for the Tenth Circuit as respects Choate, in the Circuit Court of Appeals for the Fifth Circuit as respects Hogan. The Commissioner won in the Tenth Circuit (141 F. 2d 641) and lost in the Fifth. *Hogan* v. *Commissioner*, 141 F. 2d 92. It was to resolve that conflict that we

granted the petition in the present case limited to that single question.

The Commissioner makes an elaborate argument based on the assumption that there was no sale of the equipment. The assumption is that after the partnership transferred its interest in the lease its investment was no longer in the leasehold and equipment as such but was an economic interest in an oil producing enterprise—an interest which is depletable since it is measured by the production of oil. But there are two difficulties with that argument. In the first place, we find nothing in the Revenue Act of 1938, 52 Stat. 447, or in the Treasury Regulations which provides for depletion of equipment used in the operation of oil and gas wells. A deduction is allowed for depreciation by § 23(l) which permits a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business". And see Treasury Regulations 101, Art. 23(m)-18. Sec. 23(m) provides that in the case of "mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case" may be taken as a deduction. And see Treasury Regulations 101, Art. 23(m)-10. Depletion is applicable to wasting assets—to the exhaustion of natural resources, not of property used in a business. See 4 Mertens, Law of Federal Income Taxation (1942) § 24.02. That distinction between depletion and depreciation runs through the basis provisions of the Act. See § 111(a), § 113(a) and (b), § 114(a) and (b). And the history of the depletion provisions indeed makes clear that only intangible drilling and development costs, not costs represented by physical property, are returnable by way of depletion. See *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; 4 Mertens, *op. cit.*, § 24.48; Treasury Regulations 101, Art 23(m)-16(a). In the second place, the Tax Court found that the parties intended a cash sale of the equipment. That question is argued here as if it were open for redetermination by us. It is not. It is the kind of issue reserved for the Tax Court under *Dobson* v. *Commissioner*, 320 U. S. 489 and *Wilmington Co.* v. *Helvering*, 316 U. S. 164, 167-168. Once a sale of the equipment is conceded, it is not denied that petitioner is entitled to an allowance for the unrecovered cost of the equipment transferred. Sec. 111(a), § 113(a) and (b). No question is presented concerning the allocation of a portion of the purchase price to the equipment.

Reversed.